### UNITED WAY/CENTRAIDE Windsor – Essex County DIRECTOR AND OFFICER LIABILITY AND BEYOND

Windsor – January 19, 2005

### Part V Recent Changes to the *Income Tax Act* Affecting Charities

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#### **OVERVIEW OF PRESENTATION**

- Overview of Proposed Changes to the *Income Tax Act*
- Selected Highlights from the Revised Draft Technical Amendments of February 2004
- Selected Highlights from December 2004 Draft Amendments re the March 2004 Budget

This power point presentation consists of excerpts from a paper entitled "Essential Recent Developments in Charity Law" dated December 1, 2004 as well as Charity Law Bulletins #54, #55, #56, #59 and #61 available at <u>www.charitylaw.ca</u>

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#### A. OVERVIEW OF PROPOSED CHANGES TO THE INCOME TAX ACT

- December 20, 2002 Draft Amendments
- December 24, 2002 Income Tax Technical News No. 26
- February 28, 2003 Federal Budget
- December 5, 2003 Draft Amendments
- February 27, 2004 Revised Draft Technical Amendments
- March 23, 2004 Federal Budget
- September 16, 2004 Draft Amendments for March 2004 Federal Budget
- December 6, 2004 Ways and Means Motion (December 2004 Draft Amendment)

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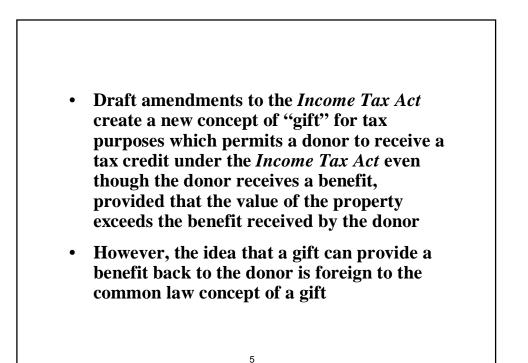
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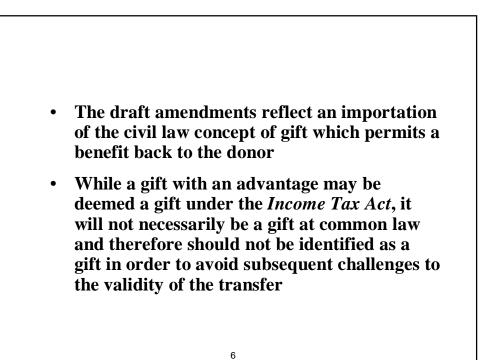
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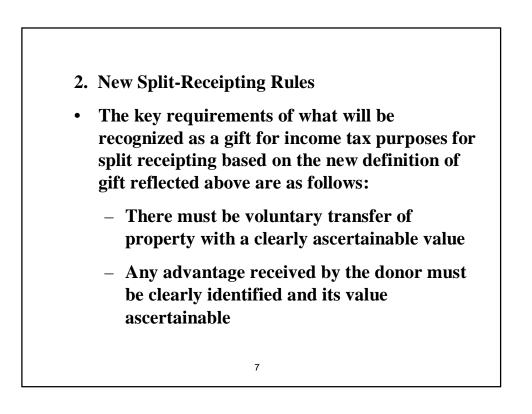
B. SELECTED HIGHLIGHTS FROM THE REVISED DRAFT TECHNICAL AMENDMENTS OF FEBRUARY 2004

- 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
  - The transfer must be made voluntarily without contractual obligation
  - No consideration or advantage can be received by the donor

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- 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

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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



• 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

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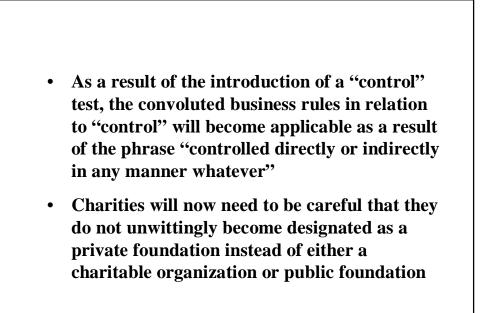
- Therefore, if a donor makes a gift in consideration of the charity employing his spouse, or the charity hires his spouse in gratitude of the gift being made in the future, then the value of the advantage might include the current value of the employment of the spouse
  - In addition, the advantage 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

- 3. New Definition of Charitable Organizations and Public Foundations
- The definitions of charitable organizations and public foundations have been 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

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- 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





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4. 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 15

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**Description of Tax Shelter Donation Programs:** 

- The potential misuse of tax shelter donation programs has been identified by CRA
  - 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

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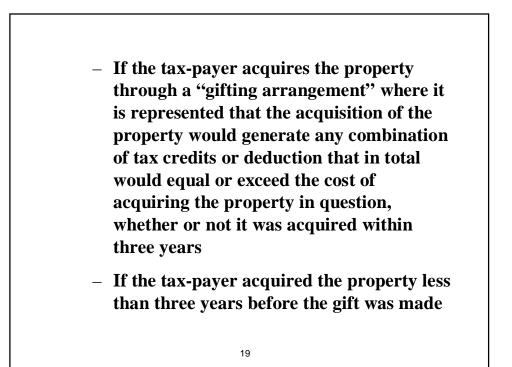
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**New Deeming Provision:** 

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 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:

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 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, with the donor presumably having to prove that the donor did not have an expectation 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

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- 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 2003 amendments with regards to gifts of property, if passed, will apply to gifts made on or after December 5, 2003

**Limited Recourse Debt:** 

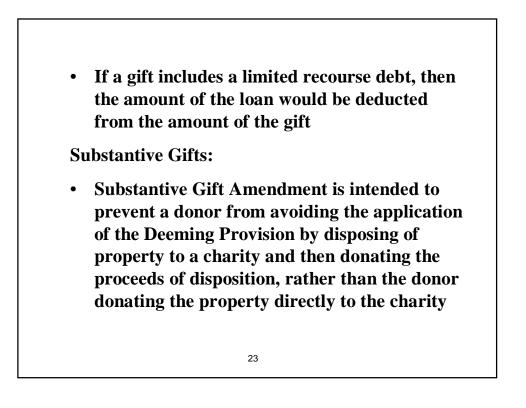
• The December 2003 draft amendments also preclude charitable receipts for limited recourse debt in respect of gifting arrangements

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• 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 is 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

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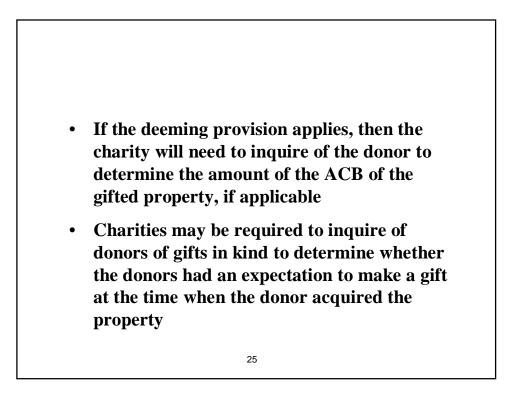
**Anti-Avoidance Rule:** 

• In addition to the deeming provision, the December 2003 draft amendments introduced an anti-avoidance rule

**Practical Implications:** 

• Charities will be required to inquire of donors of gifts 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

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- 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

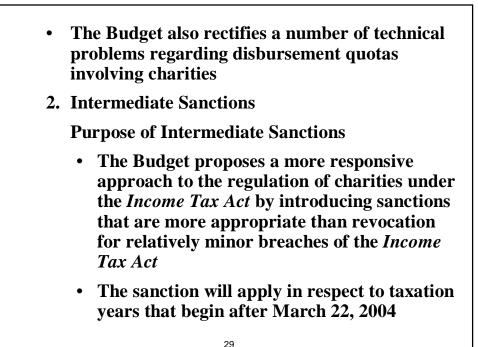
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- 5. Revocation of Registration of Charities
- Proposed amendments will permit the revocation of the charitable status of a charity if it "makes a disbursement by way of a gift" which is not a gift made "in the course of charitable activities carried 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, transferred in accordance with an authorized agency/joint venture/partnership agreement, or transferred to qualified donees (i.e. generally other registered charities)

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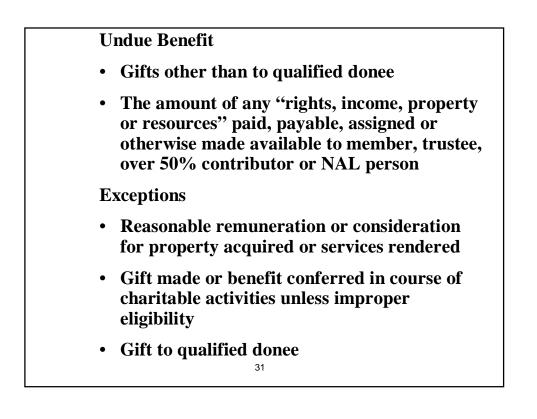
C.	SELECTED HIGHLIGHTS FROM
	<b>DECEMBER 2004 DRAFT AMENDMENTS RE</b>
	THE MARCH 2004 BUDGET
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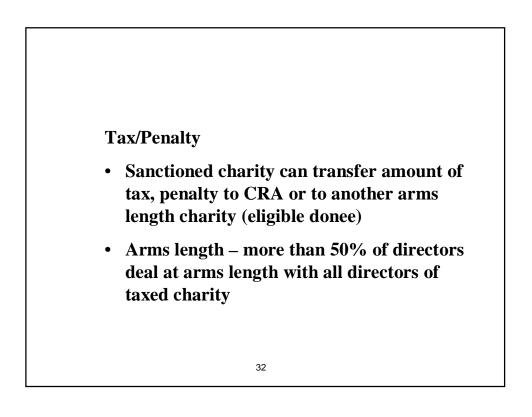
- 1. Overview
- The March 2004 Federal Budget (the "Budget") includes a major initiative by the Federal Government in rewriting the tax rules concerning charities
- Draft enabling legislation from the Budget was • initially released on September 16, 2004
- Ways and Means Motion introduced on December 6, 2004 is the enabling legislation (December 2004 draft amendment)
- The Budget reflects the proposals of the Voluntary Sector Initiative's Joint Regulatory Table, particularly as it relates to intermediate sanctions for charities



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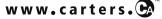
Offence	First Infraction	Repeated Infraction (Within 5 years)
Late filing or failure to file T3010A     Issuing incomplete receipts     Carrying on prohibited business activity         Private foundation – any business         Public foundation/organization –         unrelated business     Foundation acquiring control of corporation     Undue personal benefit     Transfer among charities to avoid     disbursements quota (joint and several     liability with recipient charity)	<ul> <li>\$500 penalty</li> <li>Penalty of 5% of eligible amount stated on receipt</li> <li>Tax of 5% on gross revenue from activity</li> <li>5% tax on dividends paid to charity</li> <li>Penalty of 105% of benefit</li> <li>Tax of amount transferred and 10% of amount transferred</li> </ul>	\$500 penalty May lead to Revocation     Penalty of 10% of eligible amount stated on     receipt     Tax of 100% on gross revenue from activity     and suspension of receipt privileges     100% tax on dividends paid to charity     Penalty of 115% of benefit and suspension of     tax receipt privileges     Tax of amount transferred and 10% of amount     transferred
<ul> <li>Issuing receipts in taxation year that do not exceed \$20,000 if no gift or if receipt contains false information.</li> </ul>	125% tax on eligible amount of receipt	<ul> <li>125% tax on eligible amount of receipt</li> </ul>
<ul> <li>Issuing receipts totaling more than \$20,000 if no gift or receipt contains false information</li> </ul>	<ul> <li>Tax of 125% of amount receipted and suspension of tax privileges</li> </ul>	<ul> <li>Tax of 125% of amount receipted and suspension of tax privileges</li> </ul>
<ul> <li>Failure to comply with certain verification and enforcement requirements (ex. Keeping proper books and records)</li> </ul>	Suspension of tax receipting privileges	Suspension of tax receipting privileges





#### Revocation

- Still available for any offence and can be applied with intermediate sanctions
- The charitable status of a charity may be revoked if it obtained its registration status on the basis of false, misleading or omitted information
- Revocation Tax
  - In lieu of paying revocation tax to CRA
    - Equivalent amount can be paid to eligible transferees i.e. other registered charities dealing at arms length (pre budget the revocation tax would be paid to a "qualified donee" but CRA concerned about transfers to NAL charities)



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	• Pre budget – revocation tax applied 1 year after revocation
	<ul> <li>Proposed amendments – tax assessed immediately, collection suspended for one year</li> </ul>
3.	Annulment
•	Where registration obtained in error or if charity ceases to be a charity because of changes in the law
	<ul> <li>No effect on issued receipts</li> </ul>
	<ul> <li>No 100% Part V revocation tax or other penalty will be charged</li> </ul>
•	Useful tool – permits errors to be rectified without negative public notice which goes with Notice of Revocation <sup>34</sup>

- 4. Appeals Regime
- Pre Budget
  - Federal Court of Appeal judicial review
  - No administrative appeal process
  - Costly, ineffective
- Post Budget

**Internal Reconsideration Process** 

- The Budget will extend the application of CRA's existing internal objection review process to notices of a decision regarding
  - Denial of applications for charitable status
  - Revocation or annulments of a charity's registration

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- Designation of a charity as a private or public foundation or charitable organization
- Imposition of any taxes or penalties against a registered charity

**External Appeals Process** 

- Appeals of intermediate taxes and penalties means trial de novo to Tax Court of Canada (after going through internal process)
- Appeals of refusal to register, revocation, annulment, charitable designation is done by way of judicial review to Federal Court of Appeal

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Stay of Appeal
Revocation
revocations – 1<sup>st</sup> proposed by notice
MNR may then revoke 30 days after notice
Right of charity to appeal revocation and decision begins at time of notice
practice of CRA – not to actually revoke until appeal to CRA has run its course
review if CRA not accommodating – can appeal to Federal Court of Appeal for stay pending court decision

#### - Suspension of receipting privileges

- takes effect 7 days after notice mailed
- charity may apply to Tax Court for postponement of beginning of suspension
- court may only postpone if finds it is "just and equitable" to do so
- not necessary to file appeal to request postponement
- Appeals of penalty tax
  - usual stay pending appeal applies

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- 5. Additional Information Available to Public Increased Transparency
  - Financial information
  - Registration/annulment correspondence from CRA
  - CRA decisions re objections to assessment of tax or penalties
  - Material filed and CRA responses re requested exemption, special status (ex. permission to accumulate)
  - Information detailing application of sanctions
    - Identification of charity
    - Sanction imposed
    - Grounds for sanction

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- Increased website information
  - Reasons for registration decisions
  - Policies
  - Procedures
  - Research database
- Will help charities in regulating their activities and to comply with law and CRA administrative positions
- Additional Information required on official tax receipts starting in 2005
  - Name and website address of CRA
- Charities Advisory Committee
  - Greater impact by charities into shaping of tax rules affecting charities

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- 6. Disbursement Quota Rules
- a) Overview
- The December 2004 draft amendments include significant changes to the calculation of the disbursement quota
- It has made an already complicated formula even more difficult and unworkable
- The disbursement formula has been amended to provide as follows:

A + A.1 + B + B.1 (where B.1 =C x 0.035[D - (E + F)]/365)



b) Proposed changes to Disbursement Quota Formula

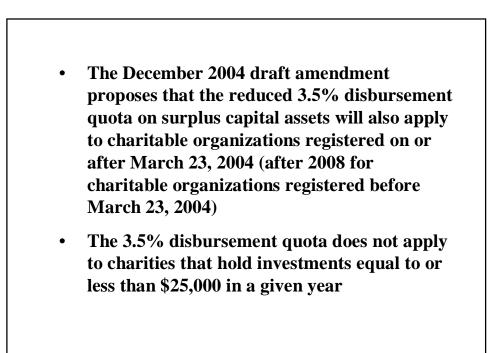
**Reduction of Disbursement Quota Rate** 

• The December 2004 draft amendment proposes to reduce the 4.5% disbursement quota that currently applies to public and private foundations to a more manageable disbursement quota of 3.5%

Extension of 3.5% Disbursement Quota to Charitable Organizations

• In the past, only public and private foundations were subject to a disbursement quota upon its capital assets not used in charitable activities

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**Realizing Capital Gains from Endowments** 

- The previous anomaly that 80% of the disbursement of the capital gain of a ten year gift had to be added to the disbursement quota of a charity is now alleviated by reducing the 80% disbursement quota by the lesser of 80% of the capital gain realized on the disposition and 3.5% of capital assets not needed in charitable activities
- The December 2004 draft amendment proposes to combine 10 year gifts and gifts of capital property from estates under the new term of "enduring property"

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Enduring property also includes a gift

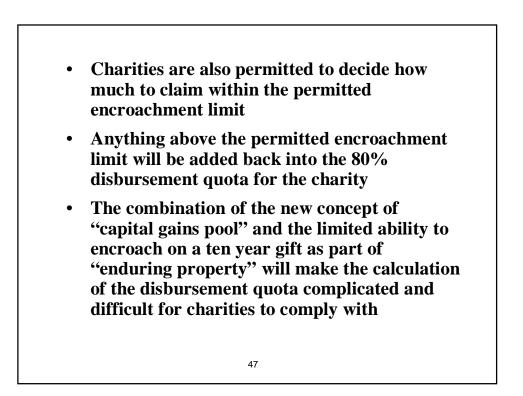
received by a charitable organization from another registered charity, and
where the majority of the directors of the donor charity deal at arm's length with the recipient charitable organization,
provided that the gift is subject to a trust or direction that the gift be utilized over a period not exceeding 5 years in its charitable program

**Capital Gains Pool** 

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- The December 2004 draft amendment also introduces the concept of a "capital gains pool", which is in essence consists of the amount of capital gains of a charity resulting from disposition of "enduring property"
- A charity will now be able to encroach on the capital gains of a ten year gift, provided that the terms of the gift so permit, but only up to the lesser of the amount of the 3.5% disbursement quota and the amount in the "capital gains pool"

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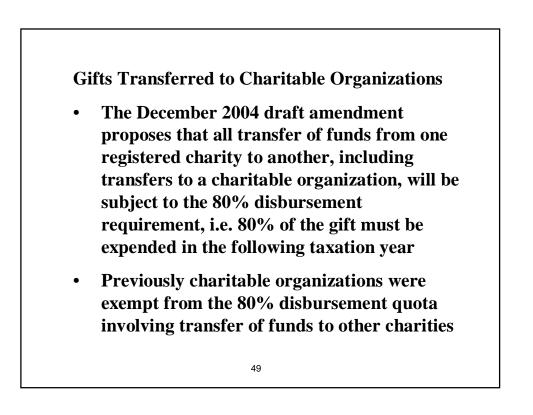




**Transfer of "Enduring Property"** 

- "Enduring property" (which includes 10 year gifts) is not included in the 80% disbursement quota in the following taxation year
- The December 2004 draft amendment proposes that "enduring property" received by a registered charity from another registered charity will result in the same treatment of that gift as if the "enduring property" had been received directly from the original donor, i.e. 80% of it will not need to be expended in the following taxation year

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- Now gifts to charitable organizations will need to comply with the specified gift rules in order to avoid having to expend 80% in the following taxation year unless it is a transfer of "enduring property"
  - There will therefore be three choices in categorizing inter charity transfers
    - Undesignated transfer
    - Enduring property
    - Specified gift
  - However, problems in the disbursement quota formula can occur for the transferring charity if an enduring property is designated in the transfer as a specified gift

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- c) Gifts Made By Way Of Direct Designation
- Where an individual has designed in his/her will a charity as a direct beneficiary of the individual's RRSP, RRIF or life insurance policy, the December 2004 draft amendment proposes to treat such gifts as "enduring property" for the purposes of the disbursement quota rules
- This will mean that direct designation of RRSP, RRIF and life insurance proceeds will be subject only to the 3.5% disbursement quota while they are held as capital and then subject to the 80% disbursement quota requirement in the year in which they are disbursed

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