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# FOUNDATION OF GUELPH GENERAL HOSPITAL

Guelph – November 24, 2005

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## Recent Amendments to the *Income Tax Act* Affecting Charities and Donors (as of November 21, 2005)

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**RESOURCE MATERIALS**

This power point presentation consists of excerpts from:

- A paper entitled “Recent Changes to the *Income Tax Act* Affecting Charities and Gift Planning” dated March 16, 2005
- A paper entitled “New Disbursement Quota Rules Under Bill C-33” dated May 6, 2005
- Charity Law Bulletins #54, #55, #56, #59, #67, #69, #76, #77 and #80

all available at [www.charitylaw.ca](http://www.charitylaw.ca)

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**A. KEY POINTS TO REMEMBER**

May /2005 Amendments

- The 4.5% disbursement quota is reduced to 3.5%
- The 3.5% disbursement quota is extended to charitable organizations
- Gifts transferred to charitable organizations are now subject to the 80% disbursement quota
- The 80% disbursement quota can be delayed through utilizing “enduring property” including ten year gifts

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- Inter-charity transfers have become more complicated
- Failure to comply with rules for registered charities can result in intermediate sanctions and penalties
- “Undue Benefit” rules will now apply when remunerating officers, staff, members and volunteers
- New internal appeals process is available

July/2005 Proposed Amendments

- A gift will permit some consideration to be received by the donor

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- New split receipting rules will apply
- New broader definition of “advantage” may reduce the amount of a charitable receipt
- New broader definition of a charitable organization and public foundation will apply
- Complicated new anti-tax shelter provisions may result in reduction of charitable receipts for gifts in kind
- Charities will need to make “reasonable inquiries” of donors for all gifts over \$5,000.00, whether gifts in kind or cash
- New expanded basis for revocation of a charity will apply

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- B. OVERVIEW OF RECENT CHANGES TO THE *INCOME TAX ACT***
- Proposed Technical Amendments:**
- 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
  - July 18, 2005 Special Release – Legislative Proposals Relating to Income Tax

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- Legislation Implementing Regulatory Reform and Disbursement Quotas:**
- March 23, 2004 Federal Budget
  - September 16, 2004 – Draft Legislation
  - December 6, 2004 Ways and Means Motion – Bill C-33 from March 2004 Federal Budget
  - May 13, 2005 Passage of Bill C-33 (May 2005 Amendments)

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**C. HIGHLIGHTS OF MAY 2005 AMENDMENTS**

**1. Overview**

- The May 2005 Amendments reflect the proposals of the Voluntary Sector Initiative's Joint Regulatory Table, particularly with respect to intermediate sanctions for charities
- The May 2005 Amendments also sought to rectify a number of technical problems with the disbursement quota rules
- The resulting legislative provisions are complex and will be very challenging for charities to comply with

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**2. New Disbursement Quota Rules ("DQ")**

**a) Introduction**

- **What is DQ?**
  - A prescribed amount that registered charities must disburse each year in order to maintain their charitable registration
- **Purpose**
  - To ensure charities use charitable funds on charitable activities
  - To discourage charities from spending excessive amounts on fundraising and from accumulating funds

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**b) Changes to Disbursement Quota**

**Formula:**

**Reduction of Disbursement Quota Rate**

- The May 2005 Amendments reduce the 4.5% disbursement quota that previously applied to the capital assets of public and private foundations to a more manageable rate of 3.5%

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**Extension of 3.5% Disbursement Quota to Charitable Organizations**

- In the past, only public and private foundations were subject to a separate disbursement quota upon their capital assets not used in charitable activities
- The reduced 3.5% disbursement rate will now apply immediately to charitable organizations registered on or after March 23, 2004 (after 2008 for charitable organizations registered before March 23, 2004)

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**Disbursement Quota Threshold**

- The 3.5% disbursement quota will not apply to charities that hold investments equal to or less than \$25,000 in a given year
- This *de minimus* threshold is generally considered to be too low to be of much relief for most small charities

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**Gifts Transferred to Charitable Organizations**

- Previously charitable organizations were exempt from the 80% disbursement quota involving transfer of funds from other charities
- Now, all transfers of funds from one registered charity to another, including transfers to a charitable organization (but excluding transfers of enduring property) will be subject to the 80% disbursement obligation, i.e. 80% of the gift must be expended in the following taxation year

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**Enduring Property**

- The amendments combine 10 year gifts and gifts of capital received by way of bequest on inheritance under the new term of “enduring property”
- Enduring property also includes 5 year gifts, i.e. gifts:
  - received by a charitable organization from a 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 expended in its entirety over a period not exceeding 5 years in its charitable program or acquiring capital property for charitable activities on administration

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**Enduring Property Also Includes Gifts Made by way of Direct Designation**

- Where an individual has designated in his/her will a charity as a direct beneficiary of the individual’s RRSP, RRIF or life insurance policy, the May 2005 amendments 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 in the year in which they are disbursed

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**Encroachment on Enduring Property**

- New concept introduced of a “capital gains pool”, which is a notional account to keep track of the amount of capital gains realized by a charity from the disposition of “enduring property”
- A charity will now be able to encroach on these capital gains, provided that the terms of the gift permit such encroachment, 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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- Charities will be able to decide how much to claim within the permitted encroachment limit of the capital gains pool but charities will need to track their capital gains pool each year on their T3010A
- The combination of the yearly tracking requirement for the “capital gains pool” and the determination of what is a capital gain will make the calculation of the disbursement quota challenging for charities to comply with

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**Inter-Charity Transfers**

- Enduring property received by a registered charity from another registered charity will result in the same treatment by the recipient as if the enduring property had been received directly from the original donor, i.e. 80% will not need to be expended in the following taxation year

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- Gifts to charitable organizations from another registered charity 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 tracking inter-charity transfers
  - Ordinary gifts (i.e. not specified gifts nor enduring property)
  - Specified gifts
  - Enduring property (that are not received as specified gift), including 10 year gifts, 5 year gifts, gifts of capital from estates and gifts by way of direct designation

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- **Ordinary gifts**
  - i.e., neither specified gifts, nor enduring property
  - For the transferor charity, the transfer can be used to satisfy its DQ obligation
  - For the transferee charity, there will be an obligation to expend the gift in the following year
  - If the transferee charity is either a charitable organization or a public foundation, the DQ obligation is 80% of the gift

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- If the transferee charity is a private foundation, the DQ obligation is 100% of the gift
- For example: \$100 ordinary gift transferred from Charity A to Charity B

	Transferor Charity A		Transferee Charity B	
	DQ obligation	DQ satisfaction	DQ obligation	DQ satisfaction
Year 1	N/A	\$100 expended can be used to satisfy its DQ obligations of Charity A in year 1	<ul style="list-style-type: none"> <li>•Charitable organizations and public foundations have to expend \$80 in year 2</li> <li>•Private foundations have to expend \$100 in year 2</li> </ul>	N/A

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- When Charity B expends the ordinary gift in the following year, Charity B can use the expenditure to satisfy its DQ obligation in year 2 mentioned above

	Transferee Charity B	
	DQ obligation	DQ satisfaction
Year 2	N/A	The \$ expended can be used to satisfy DQ obligation in year 2

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- Specified gifts
  - For the transferor charity, the transfer cannot be used to satisfy its DQ obligation
  - For the transferee charity, there is no obligation to expend the specified gift in the following year and thus the gift becomes “DQ free” of the 80% DQ

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– For example: \$100 specified gift transferred from Charity A to Charity B

	Transferor Charity A		Transferee Charity B	
	DQ obligation	DQ satisfaction	DQ obligation	DQ satisfaction
Year 1	N/A	— Charity A cannot use the \$100 to satisfy its DQ obligation in year 1	— Charity B is <u>not</u> obligated to expend any of the \$100 subsequent years	N/A

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– When Charity B expends the specified gift in a subsequent year, Charity B can use the expenditure to satisfy its other DQ obligations in that year

	Transferee Charity B	
	DQ obligation	DQ satisfaction
Year 2	N/A	\$100 expended can be used to satisfy other DQ obligations in that year

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- **Enduring property**
  - The following rules do not apply to enduring property received as specified gifts
  - For the transferor charity, there will be a DQ obligation to expend the enduring property in the year
  - The DQ obligation is met by the transfer itself
  - For the transferee charity, there is no obligation to expend the enduring property in the following year
  - For example: \$100 enduring property transferred from Charity A to Charity B

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	Transferor Charity A		Transferee Charity B	
	DQ obligation	DQ satisfaction	DQ obligation	DQ satisfaction
Year 1	Charity A will be obligated to expend 100% of the fmv of the enduring property in year 1	The DQ obligation created by the transfer is met by the transfer itself	--- no effect on DQ	--- no effect on DQ until Charity B expends the gift

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- When Charity B expends the enduring property in a subsequent year, Charity B will be obligated to expend at least 80% of the enduring property
- The DQ obligation in that year would be met by the expenditure of the enduring property

	Transferee Charity B	
	DQ obligation	DQ satisfaction
Subsequent Year	Charity B will be obligated to expend at least \$80 in the year	The \$ expended can be used to satisfy DQ obligation in the year

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- However, if Charity A designates the enduring property as a specified gift, then Charity A would not be able to use the expenditure to satisfy its DQ obligation in the year of transfer
- Charity B would receive the enduring property as a specified gift, which would not create any DQ obligation to expend the specified gift
- When Charity B expends the gift in a subsequent year, Charity B would be able to use the expenditure to satisfy its other DQ obligations in that year
- Limited reasons for the transferor charity to agree to transfer the enduring property as a specified gift

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	Transferor Charity A		Transferee Charity B	
	DQ obligation	DQ satisfaction	DQ obligation	DQ satisfaction
Year 1	Charity A will be obligated to expend \$100 in year 1	Charity A cannot use the \$100 to satisfy its DQ obligation in year 1	Charity B is not obligated to expend any of the \$100 in following year	N/A
Subsequent Year	N/A	N/A	N/A	\$100 expended can be used to satisfy other DQ obligations in that year

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- 2. Intermediate Sanctions**
- Purpose of Intermediate Sanctions**
- The May 2005 amendments establish a more responsive approach to the regulation of charities under the *Income Tax Act* by introducing sanctions that are more appropriate than revocation for relatively minor breaches of the *Income Tax Act*
  - The sanctions will apply in respect of taxation years that begin after March 22, 2004

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Offence	First Infraction	Repeated Infraction (Within 5 years)
<ul style="list-style-type: none"> <li>Late filing or failure to file T3010A</li> <li>Issuing incomplete receipts</li> <li>Carrying on prohibited business activity                             <ul style="list-style-type: none"> <li>Private foundation – any business</li> <li>Public foundation or charitable organization – unrelated business</li> </ul> </li> <li>Foundation acquiring control of corporation</li> <li>Failure to comply with certain verification and enforcement requirements (e.g. keeping proper books and records)</li> </ul>	<ul style="list-style-type: none"> <li>\$500 penalty</li> <li>Penalty of 5% of eligible amount stated on receipt</li> <li>Tax of 5% on gross revenue from the offending activity</li> <li>5% tax on dividends paid to charity</li> <li>Suspension of tax receipting privileges</li> </ul>	<ul style="list-style-type: none"> <li>\$500 penalty. May lead to revocation</li> <li>Penalty of 10% of eligible amount stated on receipt</li> <li>Tax of 100% on gross revenue from the offending activity and suspension of receipt privileges</li> <li>100% tax on dividends paid to charity</li> <li>Suspension of tax receipting privileges</li> </ul>

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Offence	First Infraction	Repeated Infraction (Within 5 years)
<ul style="list-style-type: none"> <li>Issuing receipts in taxation year if there is no gift or if receipt contains false information</li> <li>Transfer among charities to avoid disbursements quota (joint and several liability with recipient charity)</li> <li>Undue personal benefit</li> </ul>	<ul style="list-style-type: none"> <li>125% tax on eligible amount of receipts (suspension of tax receipting privilege of total penalties under 188.1(9) exceeds \$25,000 in a taxation year)</li> <li>Tax of amount transferred and 10% of amount transferred</li> <li>Penalty of 105% of benefit</li> </ul>	<ul style="list-style-type: none"> <li>125% tax on eligible amount of receipts (suspension of tax receipting privilege of total penalties under 188.1(9) exceeds \$25,000 in a taxation year)</li> <li>Tax of amount transferred and 10% of amount transferred</li> <li>Penalty of 115% of benefit and suspension of tax receipt privileges</li> </ul>

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<p><b>Undue Benefit</b></p> <ul style="list-style-type: none"> <li>Gifts other than to qualified donee</li> <li>The amount of any “rights, income, property or resources” paid, payable, assigned or otherwise made available to member or trustee of the charity, or a person who contributed more than 50% of the capital of the charity, or a non arms length person</li> </ul> <p><b>Exceptions</b></p> <ul style="list-style-type: none"> <li>Reasonable remuneration or consideration for property acquired or services rendered</li> <li>Gift made or benefit conferred in course of charitable activities unless improper eligibility</li> <li>Gift to qualified donees</li> </ul> <p style="text-align: center;">34</p>
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**Tax/Penalty**

- Sanctioned charity can transfer the amount of tax or penalty to CRA or to another arm's length charity (eligible donee)
- Arm's length – more than 50% of directors deal at arms length with all directors of the sanctioned charity

**Revocation**

- Still available for any offence and can be applied with intermediate sanctions
- The charitable status of a charity may also be revoked if it obtained its charitable registration status on the basis of false, misleading or omitted information

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**Revocation Tax**

- In lieu of paying revocation tax to CRA, equivalent amount may be paid to eligible donees, i.e. other registered charities dealing at arm's length

**Annulment**

- Where registration obtained in error or if charity ceases to be a charity because of changes in the law
  - No effect on issued receipts
  - No 100% Part V revocation tax or other penalty will be charged
- Useful tool – permits errors to be rectified without negative public notice which goes with notice of revocation

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**3. Appeals Regime**

**Pre Budget**

- Federal Court of Appeal judicial review
- No administrative appeal process
- Costly, ineffective

**Post Budget**

- Significantly changes the procedures for appeals
- Generally an improved process

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**Internal Appeals Process**

- **CRA’s existing internal objection review process is extended to Notices of Decision regarding**
  - Denial of applications for charitable status
  - Revocation or annulment of charitable status
  - Designation of a charity as a private or public foundation or charitable organization
  - Imposition of any taxes or penalties against a registered charity

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**Judicial Review Process**

- **Appeals of intermediate sanctions and penalties entitled to trial de novo before Tax Court of Canada**
- **Appeals of refusals to register, revocation, annulment, and charitable designation are by judicial review application to Federal Court of Appeal**
- **Both can occur only after Notice of Objection has been filed as part of internal review process and 90 days have passed**

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**4. Additional Information Available to Public  
Increased Transparency**

- **Financial information**
- **Registration/annulment correspondence from CRA**
- **Material filed and CRA responses regarding requests for exemption and special status**
- **Information detailing application of sanctions**
  - Identification of charity
  - Sanction imposed
  - Grounds for sanction
- **CRA decisions regarding objections to assessment of tax or penalties**

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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**
- **Charities Advisory Committee**
  - Opportunity for sector to have input

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**D. HIGHLIGHTS OF THE JULY 2005 SPECIAL RELEASE**

**1. Meaning 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; and
  - no consideration or advantage can be received by the donor

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- **2005 draft amendments to the *Income Tax Act* create a new concept of “gift” for tax purposes which permits a donor to receive benefit, provided that the value of the property donated exceeds the benefit received by the donor**
- **Concept is commonly referred to as “split-receipting”**

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- The 2005 draft amendments reflect an importation of the civil law concept of gift which permits a benefit back to the donor
- While a gift with an advantage may be deemed a gift under the *Income Tax Act*, it will not necessarily be a gift at common law and therefore should not be identified as a gift in order to avoid subsequent challenges to the validity of the transfer

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2. New Split-Receipting Rules

- The key elements of what will be recognized as a gift for income tax purposes are as follows:
  - There must be voluntary transfer of property with a clearly ascertainable value
  - There must be a clear donative intent by the donor to benefit the charity

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- 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
- Any advantage received by the donor must be clearly identified and its value ascertainable

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– The amount of the advantage is the total value of all property, services, compensation, use 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 to receive (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

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- The charitable receipt will now need to identify the advantage and the amount of the advantage, as well as the eligible amount of the 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 will necessitate that charities make inquiries of donors to determine if they have received a related benefit from anyone

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**3. New Definitions 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 obligations
- 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-arm’s length relationship with 50% or more of the directors or trustees of the charity

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- 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

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**4. The Evolving Shutdown of Tax Shelter Donation Programs**

**Definition of Tax Shelter:**

- Tax shelter is defined under the *Income Tax Act* as a promotion which 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

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- This meant that tax shelter donation programs with promises of net return on investments were required to be registered as tax shelters
- The potential misuse of tax shelter donation programs has been identified by CRA in numerous publications
- These donation programs turn on the fact that the item in question is purchased at a substantially lower price than its purported 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

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- The December 2003 and February 2004 proposed amendments to the *Income Tax Act* attempted to shut down tax shelter donation programs by severely restricting the tax benefits from donations made under tax shelter donation arrangements

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**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:

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- If the tax-payer acquires the property through a “gifting arrangement” 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
- If the tax-payer acquired the property less than three years before the gift was made

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- If the taxpayer acquired the property less than 10 years before making the gift, if it was reasonable to conclude that when the taxpayer acquired the property one of the main reasons for the acquisition was to make the gift (donor must prove that the donor did not have an expectation to make a gift when the property was acquired)
- New provision also requires a “look-back” to see if the property had been acquired within the 3 or 10 years by a non-arm’s length person

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- The deeming provision does not apply to inventory, real property or an immovable situated in Canada, certified cultural property, publicly traded shares and ecological gifts
- The deeming provision also does not apply to situations where the gift is made as a consequence of the donor's death, a shareholder has transferred property to a controlled corporation in exchange for shares and the shares are donated, or a rollover transaction to a corporation for the same purpose of donating shares

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- Limited Recourse Debt:**
- The proposed amendments also preclude charitable receipts for limited recourse debt in respect of gifting arrangements (commonly referred to as "leveraged loans" or "leveraged donation schemes")
  - 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

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- 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
- If a gift includes a limited-recourse debt, then the amount of the loan would be deducted from the amount of the gift

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**Substantive Gifts:**

- Amendments related to “substantive gifts” are 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

**Anti-Avoidance Rule:**

- In addition to the deeming provision, the amendments include an anti-avoidance rule

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**5. Reasonable Inquiry/Information from Donor**

- Charities issuing a receipt for any gift with an eligible amount in excess of \$5,000 will be required to make “reasonable inquiry” as to the existence of any circumstances in respect of which the new split-receipting or tax shelter rules might apply to cause the eligible amount to be less than the fair market value of the property donated
- Failure to make reasonable inquiry will likely result in an incorrect receipt and could trigger the imposition of intermediate sanctions

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- 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
- 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

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- Charities may be required to inquire of donors of gifts in kind to determine whether the donors had an expectation to make a gift at the time when the donor acquired the property
- The sanction imposed on the donor for failing to provide any of this information, whether or not the charity made reasonable inquiries, is for the eligible amount to be deemed to be nil – no credit or deduction in respect of the gift
- It remains unclear whether when a charity has made reasonable inquiries but the donor has not provided the required information the intermediate sanction/penalty will be applied

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- 6. Expanded Basis for 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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- 7. 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

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8. Additional Qualified Donee

- The 2005 amendments propose to expand “qualified donees” to include a municipal or public body performing a function of a 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

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