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**STEP CANADA (OTTAWA BRANCH)  
TAX LAW UPDATE – CRA & PRACTITIONERS’  
ROUNDTABLES**

**Ottawa – May 16, 2007**

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**Recent Federal Budget’s Impact on Charities**

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**By Karen J. Cooper, LL.B., LL.L., TEP.**

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1. Extension of Capital Gains Exemption to Private Foundations
2. New Proposed Excess Business Holding Rules
3. Donation of Non-Qualifying Securities
4. Loan-backs
5. Donations of Medicines

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1. Extension of Capital Gains Exemption to Private Foundations
  - Elimination of capital gains tax incurred on the donation of publicly-listed shares to private foundations made on or after March 19, 2007
  - Also applies to donations of publicly-listed securities by an arm’s length employee who acquired the security under an option granted by the employer and which will exempt the associated employment benefit from taxation

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- The budget documents indicate that this was not previously permitted because of safeguard against potential conflicts of interest, or "self-dealing," which could arise when individuals with significant holdings in a corporation also have influence over the management of a foundation's holdings of the same corporation
- Has led to donation tax shelters involving the donation of flow-through shares

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2. New Proposed Excess Business Holding Rules

- The government was concerned that persons connected with a private foundation, by virtue of the combined shareholdings between them and the foundation's, have influence that they may use for their own benefit
- This concern is addressed by introducing excess business holding regime for private foundations that complements the intermediate sanctions introduced for charities in 2004

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- The proposed regime will place limits on private foundation shareholdings that take into account the holdings of persons not dealing at arm's length with the foundation
- The new excess business holdings rules will require a private foundation to continuously monitor its holdings and acquisitions of both publicly-listed and private corporation shares

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**#1 Safe harbour – 2% or less**

- A private foundation is permitted to hold a maximum of 2% of all outstanding shares in a particular class of shares in any one corporation

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**#2 Monitoring and reporting – over 2%**

- If holdings of one or more classes of shares of a company exceeds 2% of all outstanding shares of that particular class, the private foundation will be required to report to CRA the amount of shares held at the end of the year of all classes in the corporation by the foundation, as well as by non-arm's length persons

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- The private foundation will also be required to report to CRA any “material transactions” during the year by the foundation or non-arm's length persons for any period during which the foundation was outside the safe harbour in respect of the corporation
- A material transaction involves the acquisition or disposition of more than \$100,000 worth of shares of a particular class or more than 0.5% of all outstanding shares of that class

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– Proposed disclosure of additional information by private foundations

Types of Information	Made available to
Name of corporations (if any) in respect of which a foundation is beyond the safe harbour	Public via Internet
Total percentage holdings of the foundation for those corporations	Public via Internet
Aggregated holdings of all non-arm's length parties for those corporations*	Public via Internet
Names of non-arm's length persons with holdings*	CRA only

\*amounts reported are subject to *de minimis* provisions

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#3 Divestment – over 20%

- If a private foundation is outside the safe harbour range and the foundation and non-arm's length persons together hold more than 20% of the outstanding shares of a particular class of shares of a corporation, a divestment will be required
- Penalties will be imposed if the divestment does not occur within the time periods specified by the rules

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- The length of the period within which a foundation will be required to divest itself of excess shares will depend on the manner by which the excess arose:
  - If the foundation purchased shares which would result in an excess at the end of the year, the foundation would be required to divest itself of the excess before the end of that year
  - If the excess was acquired as a result of an acquisition of shares by a non-arm's length person or by a donation to the foundation by a non-arm's length person, the foundation would be required to divest itself of the excess before the end of the subsequent taxation year

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- If the excess is the result of a donation from an arm's length party or a repurchase of shares by the corporation, the foundation would be required to divest itself of the excess before the end of the 2nd subsequent taxation year
- If the excess is the result of a donation by way of a bequest, the foundation would be required to divest itself of the excess before the end of the 5th subsequent taxation year

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– CRA will have the discretion to specify conditions under which a private foundation might defer the year of the divestment obligation by up to 5 additional years in limited circumstances, e.g. where divestment of the shares within the normal compliance period would significantly depress the share price or where necessary to accommodate the requirements of securities regulators

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**Examples of actions required by a foundation depending upon the percentage of shares held by the foundation:**

	Private Foundation (Holdings of Share Class)	Non-Arm's Length Persons (holdings of Share Class)	Action Required by a Foundation
1. Safe harbour	2% or less	Any percentage	None
2. Monitoring phase	5%	10%	Reporting required
	10%	10%	
	20%	0%	
3. Divestment required	25%	0%	Reduce holdings to 20%
	8%	14%	Reduce holdings to 6%*
	10%	17%	Reduce holdings to 3%*
	Above 2%	Above 18%	Reduce holdings to 2%*

Reproduced from Annex 5 of the Budget Plan, Department of Finance, 19 March 2007.

\*Alternatively, non-arm's length persons could reduce their holdings until the combined holdings of the foundation and non-arm's length persons did not exceed 20%.

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- **Non-arm's length persons**
  - A private foundation outside the safe harbour with respect to a corporation will be required to report in respect of the holdings in that corporation of persons not dealing at arm's length with the foundation (section 251 of the *Income Tax Act*)
  - Such persons will include any person, or member of a related group of persons, that controls the foundation, and any person not dealing at arm's length with such a controlling person or group member

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- However, a person may be considered to be dealing at arm's length from the controlling person or member if the person is at least 18 years of age and living separate and apart from the controlling person or member, and the foundation applies to the Minister of National Revenue for a determination of this question of fact
- Reporting will not be required in respect of non-arm's length persons who hold less than \$100,000 worth of shares of a particular class and less than 0.5% of all the outstanding shares of a class

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- **Exemptions**
  - No obligation to divest will be imposed on donations of shares made before March 19, 2007, that were made subject to a trust or direction that they be retained by the foundation, if the terms of the gift prevent the foundation from disposing of them

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- The same exemption applies to donations made on or after March 19, 2007 and before March 19, 2012 pursuant to the terms of a will signed or an *inter vivos* trust settled before March 19, 2007 and not amended after that date
- However, these shares will be taken into account in determining the application of the excess business holdings regime to other shareholdings

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- **Penalty**
  - A penalty will apply in respect of a foundation's excess business holdings that have not been divested as required
  - The proposed penalty is 5% of the value of excess holdings, increasing to 10% if a second infraction occurs within 5 years
  - If a private foundation is subject to such a penalty and has failed to provide information as required in respect of the particular shares, the penalty will be doubled

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- **Transition**
  - Private foundations may divest, over a period of 5 to 20 years, excess business holdings existing as of March 18, 2007 at a rate of 20% every 5 years until the excess is eliminated
  - All donations or other acquisitions during the transitional period will be subject to the compliance periods for excess business holdings

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– To encourage private foundations with excess holdings to divest in a timely fashion, donations made to a private foundation which has not completed its transition by the end of its first taxation year beginning after March 18, 2012 will be subject to tax on any capital gains resulting from the disposition

- See Charity Law Bulletin #113

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**3. Donation of Non-Qualifying Securities**

- Existing donations of “non-qualifying securities” to private foundations is subject to serious restrictions
- A non-qualifying security is a share in a corporation that the donor does not deal with at arm’s length and whose shares are not listed on a prescribed stock exchange (private corporation shares) or a debt obligation (e.g., a promissory note) issued by a company or person that is not at arm’s length to the donor
- Also includes other non-arm’s length transactions

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- Does not include “excepted gifts,” which is a share donated to either a public foundation or charitable organization with which the donor deals at arm’s length, and the donor deals at arm’s length with each director/trustee of the recipient charity
- Gifts of private company shares by a donor who controls the company and gifts of debts (such as a promissory note issued to the donor by the donor’s company) in respect of a donor’s corporation are non-qualifying securities and will be subject to the rules

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- The 2007 federal budget proposes to extend the rules related to donations of non-qualifying securities to structures involving a trust in respect of which the charity is a beneficiary
- According to the Department of Finance, some donors have avoided these restrictions by transferring their private corporation shares into a trust in respect of which the charity is a beneficiary

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- A gift is recognized to the extent of the beneficial interest disposed of by the donor, yet the property remains under the control of the donor through the donor's control of the trust
- It is proposed that, if the donor is affiliated with the trust, the same restrictions will apply as if the donor had donated the shares in his or her own name and a donation tax credit or deduction will be denied
- This measure will apply to gifts made on or after March 19, 2007

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4. Loan-backs

- The loan-back provisions apply when a donor makes a gift to a qualified donee and within five years of the making of the gift, the donee:
  - Acquires a non-qualifying security from the donor; or
  - Allows a donor who is not at arm's length to the charity, to use the charity's property within certain time frames (subsection 118(16) and (17) of the Act)
- The rule applies to all registered charities, but only where the donor does not deal at arm's length with the charity

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- The donor has to reduce the eligible amount of the gift by the value of the property used, even if the donor is paying rent or giving the qualified donee something in exchange for the right to use the property
- The Department of Finance indicates that some charities will also accommodate arm's length donors who make their donations with the requirement that property be loaned back
- Therefore, the 2007 federal budget proposes to extend the loan back rules to include arm's length donors as well, applicable to gifts made on or after March 19, 2007

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- 5. Donations of Medicines**
- Budget proposes to allow a special deduction for corporations that make donations of medicines from their inventory to registered charities that have received a disbursement under a program of the Canadian International Development Agency with respect to activities of those charities outside of Canada

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- Currently, donations by corporations of property held in inventory are eligible for a charitable donation deduction equal to the fair market value ("FMV") of the property gifted
- However, the economic impact of this donation is reduced by virtue of the requirement in subparagraph 69(1)(b)(ii) of the *Income Tax Act* ("ITA") to include the FMV of the item in income

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- Budget is proposing to allow corporations that make donations of medicine from their inventory to claim a special additional deduction equal to the lesser of 50 percent of the amount, if any, by which the FMV of the donated medicines exceeds its cost and the cost of the donated medicine
- This measure will apply to gifts made on or after March 19, 2007

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