
BDO 2007 NATIONAL TAX SPECIALIST CONFERENCE

Toronto – January 14, 2007

**THE USE OF PRIVATE FOUNDATIONS
FOR PLANNED GIVING**

By Theresa L.M. Man, B. Sc., M.Mus., LL.B.

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Introduction

- As of December 2005, CRA indicates that there were 4,208 private foundations registered with CRA (out of a total of 82,243 registered charities) (CRA Registered Charities Newsletter No. 27, Fall 2006)
- The effective use of a private foundation could be a very useful and flexible planned giving tool for an individual
- There may be restrictions on when it is suitable to use a private foundation

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Overview of Topics

- What is a Private Foundation
- Advantages of Using Private Foundations
- Limitations on Using Private Foundations
- Factors to Consider When Establishing a Private Foundation

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1. What is a Private Foundation?

- Private foundations is one of three types of registered charities, namely
 - Charitable organizations
 - Public foundations
 - Private foundations
- Recent amendments to the *Income Tax Act* (the “Act”) seem to be blurring the distinction between the types of registered charities, particularly between a charitable organization and a public foundation

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- Charitable organization - overview
 - A charitable organization is an organization which devotes all of its resources to charitable activities carried on by the organization itself
 - It is generally considered to be a “doing” organization
 - A charitable organization may be established as a corporation, an unincorporated association or a trust
 - It cannot be controlled by a group of related directors/trustees, and no part of its income may be payable to or otherwise available for the personal benefit of a proprietor, member, shareholder, trustee or settlor

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- Charitable Foundation - overview
 - A charitable foundation is an entity which is constituted and operated exclusively for charitable purposes, which may be either a public foundation or a private foundation
 - While a charitable foundation may itself carry on a limited amount of charitable activities, charitable foundations generally provide funds to other charitable organizations or “qualified donees” so that those organizations may carry out their charitable activities — commonly considered a “spending” or “funding” organization

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– A charitable foundation may be established as either a corporation or a trust — it cannot be an unincorporated association

– There are two types of charitable foundations: a public foundation and a private foundation

– Like a charitable organization, a public foundation cannot be controlled by a group of related directors/trustees

– A private foundation is defined in the Act as simply a foundation which is not a public foundation

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• For a summary of the differences between the three types of registered charities, see Charity Law Bulletin #73

• Relationship between Directors/Trustees and Control

– There is no change proposed to the current definition for “private foundations” — there is no requirement that more than 50 per cent of the directors/trustees/officers of a private foundation must be at arm’s length and more than 50 per cent of the funds a private foundation receives may come from a donor or donors who do not deal at arm’s length with it

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– The definitions of charitable organizations and public foundations are proposed to be amended by replacing the “contribution” test with a “control” test -

▪ Amendment first proposed in December 2002, most recently proposed in November 2006 (Bill C-33, first reading on November 22, 2006)

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- 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
- 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

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- 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
- Funds provided by the federal government, provincial governments, municipalities, other registered charities that are not private foundations, or non-profit organizations are exempt

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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”
- Amendments retroactive to January 1, 2000

– 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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– Under the proposed rules, when applying the “control test”, some registered charities may find that they no longer fit under their current designation – they may apply under section 149.1(6.3) of the Act to change their designation as a result of the amendments described above will be required to apply within 90 days of when Bill C-33 receives Royal Assent

- Disbursement Quota Rules
 - All registered charities are required to expend a portion of their assets annually in accordance with a disbursement quota (“DQ”)

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– New DQ rules were enacted on May 13, 2005 (Bill C-33, 2005) and apply generally to taxation years beginning after March 22, 2004, except that, for charitable organizations registered before March 23, 2004, the 3.5% DQ will only apply to their taxation years beginning after 2008

– The new DQ rules for charitable organizations and public foundations are now the same, subject to some transitional provisions

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– The DQ rules generally involves a 80% disbursement requirement aimed at limiting administrative expenses and the 3.5% requirement aimed at preventing accumulation of funds

– The DQ rules for private foundations are very similar to those for charitable organizations and public foundations, except that private foundations must expend 100% (rather than 80%) of all amounts received from other registered charities in the immediately preceding taxation year, other than specified gifts and enduring property

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- **Related Business**
 - Charitable organizations and public foundations can carry on related businesses
 - Private foundations may not carry on any business activity
 - A private foundation that carries on business activities may be subject to a 5% penalty tax on its gross revenue from the offending activity on first infraction; increasing to 100% penalty tax on repeated infractions within 5 years, together with the suspension of receipting privileges (subsections 188.1(1), 188.1(2) and 188.2(1))
 - The private foundation’s charitable status may also be revoked (paragraph 149.1(4)(a) of the Act)

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- **Charitable Activities**
 - Private foundations may carry on their own charitable activities, and may give funds to other qualified donees
 - It is not clear from the Act whether there is any requirement on private foundations to give more than 50 per cent of their income annually to other qualified donees
 - CRA takes the administrative position that the language in the definition for “charitable foundation” implies that public foundations must disburse at least 50 per cent of their income to qualified donees

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- CRA also takes the administrative position that since the definition of “private foundation” in section 149.1(1) of the ITA provides that a private foundation is a charitable foundation that is *not* a public foundation, private foundations are not required to give at least 50 per cent of their income annually to other qualified donees
- **Borrowing**
 - Private foundations are prohibited from incurring debts other than debts for current operating expenses, the purchase and sale of investments or the administration of the charitable activities. (paragraph 149.1(4)(d) of the Act)

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– CRA was of the view that these types of debts would only include a miscellaneous type of debt, such as brokerage fees or other incidental amounts related to the purchase or the sale of investments, but not debts for the purpose of purchasing investments, or using the loan proceeds to discharge debts which were, when incurred, permitted under the Act

– In October 2005, CRA issued technical interpretation (2005-0154751I7) and revised its position to allow a foundation to incur debts for the purpose of acquiring investment

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– It is also now permitted for a foundation’s directors and members to give interest-free loans to the foundation to enable the foundation to acquire investments, pay current operating expenses or expend on charitable activities

– CRA indicated that they would continue to review debt arrangements, especially those involving non arm’s length parties, in order to ensure that there are no other issues, such as personal benefit

– See Charity Law Bulletin #86

– The same restrictions apply to public foundations, but not to charitable organizations

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• **Control of Other Corporations**

– Private foundations are prohibited from acquiring control of any corporation (paragraph and 149.1(4)(c) of the Act)

– Failure to comply with this restriction may subject the private foundation to a 5% penalty tax on dividends paid to the foundation on first infraction; increasing to 100% penalty tax on repeated infractions within 5 years (paragraph 188.1(2)(a) and 188.1(3)(b))

– The charitable registration of the private foundation may also be revoked

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– Generally, control occurs when the foundation owns 50% or more of a corporation’s issued share capital, having full voting rights under all circumstances. However, a foundation that has not purchased more than 5% of these shares but is given a block of shares that brings up its total holding to more than 50% will not be considered to have acquired control of the corporation (paragraph 149.1(12)(a) of the Act)

– The same restrictions apply to public foundations, but not to charitable organizations

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• Tax benefit of donation of certain gifts

– Special rules apply regarding donation of various types of gifts

– Donation of publicly listed securities and ecologically sensitive land to a private foundation – no exemption of capital gains tax

– Donation of non-qualifying securities is subject to serious restrictions

– Restrictions concerning loan backs and non-qualified investments

– See section of PowerPoint on “limitations”

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2. Advantages of Using Private Foundations

- Donor can retain control over assets donated to the private foundation
- Donor can retain control over the investments of donated assets
- Donor may involve other family members in the private foundation and instill altruistic philanthropic values in them

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- **Public recognition of the donor and his/her family in the community**
- **Donor can “design” what charitable causes the private foundation would support**
 - **Charitable objects set out in its constating documents**
 - **Must be exclusively charitable in nature and within the recognized four heads of charitable purposes**

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- **Foundation can be used to build up an asset base for charitable work**
- **Foundation can hold endowment funds or make endowed gifts**
- **Donor can retain privacy of his/her personal affairs**
- **Donor can control timing of his/her gift to the foundation and the timing of making gifts by the foundation**

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- 3. Limitations on Using Private Foundations**
- **Additional administrative and financial compliance requirements, e.g.**
 - **Following required corporate procedures**
 - **Corporate filings**
 - **Filing annual Registered Charities Information Returns (Form T3010)**
 - **Keeping adequate books and records**
 - **Issuing donation receipts in accordance with the requirements under the Act**

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- Subject to the applicable provincial statutes that apply to charities, e.g.
 - Oversight of the Ontario Public Guardian and Trustee
 - *Charities Accounting Act*
 - *Charitable Gifts Act*
 - *Trustee Act*
- Private foundation is subject to many restrictions under the Act in relation to its operations, e.g.
 - Cannot carry on any business activities
 - Cannot incur debts other than debts for current operating expenses, the purchase and sale of investments, or the administration of charitable activities

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- Cannot acquire control of another corporation, except by gift but within limits
- Must comply with the disbursement quota requirements
- Donation of publicly listed securities and ecologically sensitive land to a private foundation – no exemption of capital gains tax
- Donation of “non-qualifying securities” to private foundations is also subject to serious restrictions
 - A non-qualifying security is generally shares in a company with which the donor does not deal at arm’s length or obligations (e.g. debts) owned to the donor by a company with which the donor does not deal at arm’s length

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- Also include other non-arm’s length transactions
- Does not include a security that is listed on any of the prescribed stock exchanges set out in Regulation 3201
- Does not include “excepted gifts,” which is a share donated to either a public foundation or charitable organization (but *not* a private foundation) 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
- When a donor donates a non-qualifying security to a private foundation, a donation tax receipt will not be issued at the time when the donation is made

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– A receipt may be issued if, within 5 years of the donation, either the recipient private foundation disposes of the non-qualifying security or the non-qualifying security ceasing to be a non-qualifying security

– The value of the receipt issued will be the lesser of (1) the fair market value of the security at the time of the donation, and (2) the fair market value of the security at the time when it ceased to be a non-qualifying security or the fair market value of the consideration received by the private foundation that disposed of the non-qualifying security

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– For a donor who has made a gift of non-qualifying security and has realized a gain from the gift, the donor may claim a reserve under subsection 40(1.01) during the 5 year period until the gift is deemed to have been made

- 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
- Another restriction on private foundations involves rules concerning loan backs and non-qualified investments

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- Two situations trigger the loan back provisions: Within 5 years of a donor making a regular gift to a private foundation:
 - The private foundation acquires a NQS from or of the donor
 - The private foundation allows the donor (or a non-arm’s length person to the donor) who is not at arm’s length to the foundation, to use the foundation’s property within certain time frames (subsection 118(16) and (17) of the Act)
- A donor would need to be careful not to inadvertently violate the loan back provisions

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- **Private foundations holding non-qualified investments will be subject to a penalty tax if the interest payable to the foundation does not meet a minimum rate of return**
 - A non-qualified investment can include a debt, a share, or a right to acquire a share
 - In the case of a debt, it must be owing to the private foundations by:
 - A person who is a member, shareholder, trustee, settler, officer, official, or director of the foundation; or
 - A person who either alone, or as a member of a group of persons who do not deal with each other at arm's length, has contributed more than 50% of the capital to the foundation; or

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- A person who does not deal at arm's length with any person described above
- In the case of a corporation, a debt will be a non-qualified investment of the corporation if controlled by the private foundation, by any person or group of persons described above, by the foundation and any other private foundation with which it does not deal at arm's length, or by any combination of the above
- Will include a share in the capital stock of a corporation referred to above, held by the foundation, or held by persons not dealing at arm's length with the foundation; but shares listed on a prescribed stock exchange either within or outside Canada will not be included

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- e.g. a mortgage that a private foundation acquired from a director. The mortgagee must complete Form T2140, Part V Tax Return - Tax on Non-Qualified Investments of a Registered Charity, every fiscal year. The tax payable can be reduced by the amount of interest paid during the tax year. Accordingly, if the mortgagee decided to voluntarily pay interest to the foundation, it would reduce the amount of tax payable
- See CRA Registered Charities Newsletter No. 27 (Fall 2006)

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4. Factors to Consider when Establishing a Private Foundation

- Is there any charity that the donor would feel comfortable donating to that would meet the donor’s philanthropic desires and achieve the donor’s tax and estate planning?
- What would be the charitable objects of the private foundation and what types of charitable causes would the foundation support?
- What should be the legal form of the private foundation?
- Under what jurisdiction should the foundation be incorporated?

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- How should the foundation be structured? Who would be on the board and how would the donor exercise control on the foundation? Does the donor have other trusted family members who can sit on the board?
- Will the foundation receive funds from the donor, family members or other individuals?
- Will the foundation hold endowed funds or grant endowed gifts?
- Will the foundation be a passive funder or will the foundation carry on active charitable programs?

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