

HOSPITAL AND FOUNDATIONS SEMINAR SERIES  
 NEW DEVELOPMENTS IN PLANNED GIVING  
 AND CHARITY LAW

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**Working With Private Foundations**

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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)
- Private foundations are often used as a useful and flexible planned giving tool

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**WHY CHARITIES SHOULD UNDERSTAND THE RULES THAT APPLY TO PRIVATE FOUNDATIONS**

- Charities receive gifts from private foundations
- Can effectively facilitate gifts from donors when they give through their private foundations
- Improve donor relations by being able to work with their private foundations and understand the limitations that private foundations are subject to
- Avoid inadvertently be re-designated into private foundations, e.g. board composition and control by major donors

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**TYPES OF REGISTERED CHARITIES**

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

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- RULES THAT APPLY TO PRIVATE FOUNDATIONS**
- 1. 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)
  - 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 private foundations

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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

– 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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– Does not include funds provided by the federal or provincial government, municipalities, charitable organizations, public foundations, or non-profit organizations

– The convoluted business rules in relation to “control” will become applicable

– Amendments retroactive to January 1, 2000

• Charitable organizations and public foundations will now need to be careful that they do not unwittingly become designated as private foundations

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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 within 90 days of when Bill C-33 receives Royal Assent to change their designation

2. 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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**3. 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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**4. 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

**5. 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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- The same restrictions apply to public foundations, but not to charitable organizations
- 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 (2005-015475117) 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

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- 6. Control of Other Corporations**
- Private foundations are prohibited from acquiring control of any corporation (paragraph and 149.1(4)(c) of the Act)
  - The same restrictions apply to public foundations, but not to charitable organizations
  - 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))

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- The charitable registration of the private foundation may also be revoked
- 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)

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**7. Tax Benefits of Donations to Private Foundations**

- In general, the same rules apply with respect to most gifts, but special rules apply regarding donation of some types of gifts
- a) **Donation of Publicly-Listed Securities**
  - Generally, a gift of property will trigger a capital gain if the fair market value of the property exceeds its adjusted cost base
  - 2006 federal budget on May 2, 2006 - the government eliminated capital gains tax incurred on the donation of publicly-listed shares to public foundations and charitable organizations made on or after May 2, 2006

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- 2007 federal budget on March 19, 2007
  - eliminated 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 2007 federal budget indicates 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
- With the proposal of excess business holding rules in the 2007 federal budget to minimize potential conflicts of interest, the government announced the elimination of capital gains tax on donation of publicly-listed shares to private foundations

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- This makes donations of publicly-listed shares even more attractive than cash
- Led to donation tax shelters involving the donation of flow-through shares
- b) Donation of Ecologically Sensitive Land**
- 2006 federal budget on May 2, 2006 – eliminated capital gains tax on donation of ecologically sensitive property to public foundations and charitable organizations made on or after May 2, 2006
- Donation of ecologically sensitive property to private foundations continues to be subject to capital gains tax

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- c) 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 will complement 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
- #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 a private foundation’s 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 <sup>1</sup>	Public via Internet
Names of non-arm’s length persons with holdings <sup>1</sup>	CRA only

<sup>1</sup>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 upon application by the foundation, 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
  - 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

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- However, these shares will be taken into account in determining the application of the excess business holdings regime to other shareholdings
- 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

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– 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

- 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

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– All donations or other acquisitions during the transitional period will be subject to the compliance periods for excess business holdings

– 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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d) Donation of Non-Qualifying Securities

- Donation 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 include 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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- In order to ensure appropriate valuations for receipting purposes:
  - 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
  - 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

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- 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
- 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

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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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**e) Restrictions Concerning 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 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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- f) Restrictions on Non-Qualified Investments**
- 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

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- 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
- 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

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- 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
- See CRA Registered Charities Newsletter No. 27 (Fall 2006)

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**CONCLUSION**

- Rules that apply to private foundations are complicated
- Having a working knowledge of the rules that apply to private foundations can effectively facilitate gifts from donors when they give through their private foundations
- Important for charitable organizations and public foundations not to be inadvertently re-designated as private foundations
- Will need to monitor legislative changes

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