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Toronto – November 7, 2007

Donation Tax Shelters and Flow Through Shares

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

- **Donation tax shelters**
- **Common forms of abusive donation tax shelters**
- **Steps taken by the government to curtail abusive tax shelters**
- **Risks involved with abusive donation tax shelters**
- **Concerns for charities**
- **Donation of flow-through shares**
- **The future**

Note: For more information see Charity Law Bulletin #116 available at www.charitylaw.ca

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DONATION TAX SHELTERS – The Basics

- **Tax shelters gradually evolved over time to involve charitable donations of gifts-in-kind and leveraged charitable donations**
- **Early donation arrangements involved the donation of artwork**
- **Later, promoters also involved donation of other property, such as comic books, figurines, plates, stamps, jewellery, medical supplies, computer programs, educational products, food (such as rice, beans, barley grass) clothing, pharmaceutical products and software licenses**

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COMMON FORMS OF ABUSIVE DONATION TAX SHELTERS

1. Buy-low Donate-high Tax Shelters

- **A typical scenario would involve a taxpayer**
  - **Purchasing property for a low price**
  - **Donating the property to a charity, usually pre-arranged by the promoter**
  - **Receiving a donation tax receipt in an amount purported to be the fair market value of the donated property that is substantially greater than the price paid by the taxpayer**

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- **The fair market value of the donated property is usually supported by an independent appraisal, also arranged by the promoter or vendor of the property**
- **Often, the taxpayers never takes possession of the donated property, which instead is directly transferred or delivered to the charity**
- **The attractiveness of these types of "buy-low donate-high" tax shelters to taxpayers lies in the fact that the tax credit based on the high value of the receipt far exceeds the total of the taxpayer's cost in purchasing the donated property and any tax payable on any gain realised on the disposition of the donated property, resulting in a net "profit" to the taxpayer**

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2. Gifting Trust Arrangements Tax Shelters

- **A typical scenario would involve a taxpayer**
  - **Who is inclined to charitable giving**
  - **Becoming a beneficiary of a Canadian resident trust established by a non-resident settlor**
  - **Receiving a distribution of property from the trust**
  - **Donating the property distributed together with some cash to a pre-arranged charity**

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- Sometimes, a non-resident trust may be involved
- The taxpayer's adjusted cost base of the property would be equal to the trust's cost, which is fair market value, if the trust received the property in the first place as a gift
- Therefore, the donor would have no capital gain on the donated property, maximising the tax benefit the donor received

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3. Leveraged Charitable Donation Tax Shelters

- A typical scenario would involve a taxpayer
  - A taxpayer borrowing a pre-arranged loan
  - Donating the loan and some additional cash to a charity
  - Receiving a charitable donation receipt for the total amount donated
- The promoter usually arranges for the taxpayer to enter into some form of insurance policy and/or investment for a return that would, over the term of the loan, be sufficient to pay off the loan, so that the tax credit that results from the cash donation would exceed the economic cost of the cash donation to the charity, resulting in a net "profit" to the taxpayer

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STEPS TAKEN BY THE GOVERNMENT TO CURTAIL ABUSIVE DONATION TAX SHELTERS

1. Legislative Changes to the *Income Tax Act*

- 2000 federal budget:
  - Art-flip planning in the 1990s and up to February 27, 2000 shut down through an amendment to subsection 46(1)
- 2003 federal budget:
  - "Tax shelter" amended to apply to property acquired under a "gifting arrangement" in respect of which it is represented that a donation or contribution of the property would generate tax credits or deductions (such as charitable donations tax credits or deductions) equal to or exceeding the net cost of the property to the donor

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- **Charitable donation arrangements that fit within the definition of gifting arrangement are now "tax shelters" and required to be registered with the government and comply with all tax shelter reporting requirements**
- **The purpose of requiring gift arrangements to be registered is to allow CRA to be able to identify and track unacceptable donation tax shelters pursuant to subsection 237.1(8)**
- **CRA has repeatedly warned the public that the issuance of a tax shelter identification number does not indicate that CRA "guarantees an investment or authorizes any resulting tax benefits," and that CRA "only uses this identification number later to identify unacceptable tax avoidance arrangements"**

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- **December 2003 to November 2006**
  - **In December 2003, a new package of proposed amendments to the Act which have been re-introduced most recently in November 2006**
  - **In response to concerns that "various promoters are marketing charitable gifting schemes to the public" in which these "'buy-low, donate high' arrangements provide taxpayers with a tax benefit greater than their actual cost of the donated property"**

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- **Summary of amendments to curtail abusive donation tax shelters proposed as of November 2006**
  - **Deduction of "the amount of the advantage" received by the donor from the amount on the receipt, so that the "eligible amount" of a gift = the FMV of the property donation less the amount of advantage received by the donor**
  - **Requires clear donative intent by the donor to benefit the charity**

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- Broad definition of "advantage" = the total value of any "property, service, compensation, use or other benefit" in question
- Deeming the FMV of the property to be the lesser of:
  - The FMV of the property and
  - The cost (or the ACB) of the property to the tax-payer immediately before the donation

  in the following three situations:

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(i) If the donor acquired the property through a "gifting arrangement"

(ii) If the donor acquired the property less than 3 years before making the gift

(iii) If the donor acquired the property less than 10 years before making the gift, if it was reasonable to conclude that when the donor acquired the property one of the main reasons for the acquisition was to make a gift (donor must prove that the donor did not have an expectation to make a gift when the property was acquired)

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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 where the gifts is made as a result of the donor's death, and certain other situations
- The deeming provision is subject to anti-avoidance rules

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2. **Education of the Public and Registered Charities**

- **Various CRA Fact Sheets, News Release, Taxpayer Alerts warn the public and registered charities of the risks associated with involvement in such schemes**
- **Most recently: For example:**
  - ***News Release,* "Beware of tax shelter gifting arrangements," August 13, 2007**
  - ***Taxpayer Alert*, "Warning: Participating in tax shelter gifting arrangement is likely to result in a tax bill!" August 13, 2007**

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- **CRA also warns and educates the charitable sector of the risks involved with these donation schemes and the need to be wary when involved in these schemes through a series of other publications:**
  - ***Registered Charities Newsletter No. 4,* Spring 1999**
  - ***Registered Charities Newsletter* No. 14, Winter 2003**
  - ***Registered Charities Newsletter* No. 16, October 9, 2003**
  - ***Summary Policy* CSP-T08, "Tax Shelter," November 26, 2003**
  - ***Registered Charities Newsletter No. 18,* April 2004**
  - ***Registered Charities Newsletter No. 21,* January 2005**

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3. **Reassessments of Taxpayers/Donors and Court Challenges**

- **The August 13, 2007 News Release indicates that:**
  - **"CRA reviews all tax shelter gifting arrangements to ensure that the tax benefits being claimed meet the requirements of the *Income Tax Act*...Taxpayers should avoid all schemes that promise donation receipts equal to 3 or 4 times the cash payment."**
  - **CRA will audit every tax shelter gifting arrangement**
  - **CRA has audited over 26,000 individuals who have participated in these tax shelters and about $1.4 billion in claimed donations have been denied**

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- CRA will soon complete audits of another 20,000 taxpayers, involving close to $550 million in donations
- CRA is about to begin auditing another 50,000 taxpayers

• In general, the challenges by CRA have been on different fronts, including whether:
- There is a gift
- The receipts reflect the FMV of the property
- There is any donative intent (in some situations, the donor never had possession of the property before they were donated to charities)
- The property was personal-use property

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- The appraisals obtained by tax shelter promoters could be relied upon when issuing the donation receipt

4. Audits on Registered Charities and to Obtain Donor Information

• CRA has also been active in conducting audits of charities
• As part of the audit process, CRA is also obtaining donor information from the charities being audited in order to assist CRA's tax avoidance investigation or to reassess the donors

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5. Audits on Tax Shelter Promoters

• In CRA's various fact sheets and news releases, CRA has repeatedly indicated that the tax shelter identification number allows CRA to identify all tax shelters and their investors
• This also allows CRA to review and audit these shelters to ensure that they comply with the requirements of the Act

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RISKS INVOLVED WITH ABUSIVE DONATION TAX SHELTERS

1. Reassessment of Taxpayers and Penalties

- **Taxpayers involved in unacceptable donation tax shelters will be reassessed by CRA to reduce or disallow tax credits or deductions claimed**
- **In some circumstances, penalties may also be imposed on taxpayers**

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2. Third-party Penalties

- **Third-party penalties were introduced in 2000 - "to deter third parties from making false statements or omissions in relation to income tax or goods and services tax/harmonized sales tax (GST/HST) matters" and that "[t]hese penalties are directed at ensuring tax compliance by deterring behaviour that results in non-compliance"**
- **See CRA Information Circular IC 01-1, "Third-Party Civil Penalties," September 18, 2001**

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- **Third-party penalties may apply to "tax professionals, tax return preparers, accountants, advisors, practitioners, brokers, tax or financial planners, appraisers, valuators, and tax shelter promoters," and "any person … engaged in activities described in paragraphs 7 and 9."**
- **CRA indicated that third party penalties can include charities that receive the donation if "it knows – or if it can reasonably be expected to have known – that the appraised values were incorrect"**

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3. Intermediate Sanctions on Charities

- **New intermediate penalties and sanctions for registered charities that do not comply with the requirements of the Act were implemented as a result of the enactment of Bill C-33, which received royal assent on May 13, 2005**
- **Incorrect receipts - penalty equal to 5% of the amount reported on a receipt (s. 188.1(7)) and increased to 10% of the amount on the receipt upon repeat infractions within 5 years (s. 188.1(8))**
- **Such a penalty would apply to receipts that include incorrect information or receipts that do not contain all of the information required by the Act and the *Regulations***

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- **Receipts containing false statements - penalty equal to 125% of the amount shown on the receipt (s. 188.1(9))**
- ***Registered Charity Newsletter* No. 16 - charities are not obligated to either receive or receipt a gift if they choose not to**
- **In addition, CRA indicated that "[i]f the charity knew, or would have reasonably been expected to know but for circumstances amounting to culpable conduct, that the valuations were incorrect, it would be liable for the penalties for issuing false receipts"**

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4. Negative Effect on Charities' Disbursement Quota

- **CRA's *Registered Charities Newsletter* No. 16 warns that the acceptance of buy-low donate-high in-kind gifts from donors could result in the charity not being able to meet its disbursement quota.**
- **The amount for which the receipt is issued would be included in its disbursement quota requirement for the following year**

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- **If the charity was to in turn sell the property for an amount far below the amount for which the receipt was issued, the charity would not be able to meet its disbursement quota requirement as a result of the over-inflated receipt that was issued**
- **Failure to meet the disbursement quota is grounds for CRA to revoke a charity's registered status**

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5. Revocation of Charitable Status

- **In spite the enactment of intermediate sanctions against registered charities to address minor infractions of the requirement of the Act, such as the two new sanctions referred to above relating to improper issuance of donation receipts, it is still open for CRA to revoke a charity's charitable status for severe breaches of the Act. The same would apply to registered Canadian amateur athletic associations**

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DONATION OF FLOW-THROUGH SHARES

- **Flow-through shares ("FTS") are tax-based financing incentives available to the oil and gas, as well as mining sectors**
- **In the 1990s, the mining and resource industry experienced low mineral prices and therefore a downturn in exploration**
- **The government introduced an incentive to promote exploration to assist those industries to raise equity – therefore FTS**
- **The current rules effectively permit corporations to renounce or "flow-through" income tax deductions associated with certain activities to shareholders in exchange for the sale of their shares**

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- FTS are not new and FTS by themselves are generally not tax shelters, but may be if combined with a charitable donation
- Arrangement generally involves:
  - An investor invests in exploration by providing funds to a corporation in the oil and gas and mining industry
  - The investor receives shares issued by the corporation in return
  - The corporation uses the invested funds to incur various Canadian exploration and development expenses

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- The deductions available to the corporation in relation to these resource expenditures are flowed-through to the investor
- The expenditures deducted by the investor reduce the cost base of the shares held, up to the amount of the purchase price
- Once exploration is complete, the investor typically exchanges the FTS for normal securities of the issuer (on a tax deferred basis)
- Since FTS are generally deemed to have an ACB of nil, a significant capital gain will normally occur when the securities are sold

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- Instead of selling the FTS, the investor donates the FTS to a charitable organization, public foundation or private foundation
  - There is no tax on the capital gain
  - The donor receives a donation receipt for the value of the FTS donated
- Issues to consider for charities if FTS were donated to them:
  - Many FTS are subject to hold periods

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- Many FTS may not retain their value during the hold period
- Many FTS may not be marketable upon the expiration of the hold period
- Has the charity been actively involved in promoting a FTS tax shelter? - A charity may be deemed to be a promoter of a tax shelter if it is deemed by CRA to be carrying on a business and promoting the tax shelter aggressively or promoting a shelter in the course of carrying on a business

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THE FUTURE

- Looking through the crystal ball …
- Know the risks involved with donation tax shelters and then carefully review new donation programs
- Know the rules that charities are required to comply with

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