
TAX SHELTER DONATION SCHEMES

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A. INTRODUCTION

This *Charity Law Bulletin* (“Bulletin”) provides a brief overview of recent developments involving tax shelter donation schemes, including the recent announcement of proposed amendments to the *Income Tax Act* (“ITA”) on December 5, 2003. The *Bulletin* will be of interest to charities that had considered participating in a tax shelter donation scheme, but did not, as well as charities and donors who did become involved in a tax shelter donation scheme prior to the announcement of amendments to the *ITA* made on December 5, 2003 that appears to have effectively curtailed donation schemes as a tax shelter option.

The *Bulletin* provides a legislative background on tax shelters and outlines how donation schemes operate in the context of a tax shelter structure. The *Bulletin* then explains the Canada Customs and Revenue Agency’s (“CCRA”) position on tax shelter donation schemes and identifies some of the issues that a charity will need to consider if it had become involved in a tax shelter donation scheme prior to the December 5, 2003 announcement date. Portions of this *Bulletin* were excerpted from a paper presented at the Sixth Annual Estates and Trusts Forum entitled, “Recent Changes under the *Income Tax Act* and Policies Related to Charities and Charitable Gifts” on November 19, 2003, the full text of which can be accessed at <http://www.carters.ca/pub/article/charity/2003/tsc1119.pdf>.

B. EXTENDED DEFINITION OF TAX SHELTER UNDER THE FEDERAL BUDGET, 2003

Among measures announced in the Federal Budget, 2003 was a proposed amendment to broaden the definition of “tax shelter” in the *ITA*. A “tax shelter” is defined under subsection 237.1(1) of the *ITA* as any property for which a promoter represents that an investor can claim deductions or receive benefits which equal or exceed the amount invested within four years of its purchase. The definition of tax shelter has now been amended to include gifting arrangements, tax credits, refunds and deductions, since previously only deductions from income or taxable income were accounted for when determining whether or not an arrangement was a tax shelter. The newly amended section was introduced into the House of Commons via Bill-C28: *An Act to implement certain provisions of the budget tabled in Parliament on February 18, 2003*, which was passed into law on June 19, 2003.

C. TAX SHELTER DONATION SCHEMES

Tax shelter schemes, of which art and other donation schemes have gained prominence, have been the subject of considerable scrutiny by CCRA even prior to the December 5, 2003 announcement of proposed amendments to the *ITA*. The position of CCRA with regards to art-flips and other similar programs is set out in a CCRA Fact Sheet entitled “Art-donation Schemes or ‘Art-Flipping’” dated November 2002. The mechanism commonly utilized in these schemes is explained in the Fact Sheet as follows:

Step 1: A promoter gives a person the opportunity to purchase one or more works of art or another item of speculative value at a relatively low price. The proposal is that the promoter will work with the person to make arrangements for donating the works of art or other items to a Canadian registered charity or other specified institution.

Step 2: The person donates the art or other item and receives a tax receipt from the charity or other specified institution that is based on an appraisal arranged by the promoter. The appraised value of the art is substantially higher than the cost paid by the person.

Step 3: When the person claims the receipt on his or her next tax return, it generates a tax saving that is higher than the amount paid for the art in the first place.

Although the Fact Sheet deals with the donation of works of art, the donation of “another item of speculative value” is also contemplated in the publication by CCRA. These tax shelter donation schemes rested on the

fact that the item in question is purchased at a substantially lower price than its 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 to it.

CCRA's factsheet entitled "Art-donation Schemes or 'Art-Flipping'" is available at <http://www.cra-adrc.gc.ca/newsroom/factsheets/2002/nov/art-e.html>.

D. CCRA'S POSITION WITH RESPECT TO TAX SHELTER DONATION PROGRAMS

CCRA's position on tax shelter donation programs, as set out in CCRA's Fact Sheet dated November 2000 entitled "Canada Customs and Revenue Agency Reminds Investors of Risks Associated with Tax Shelters", states that registration as a tax shelter "does not indicate that the CCRA guarantees an investment or authorizes any resulting tax benefits" and that "[the] CCRA uses this identification number later to identify unacceptable tax avoidance arrangements".

In 1997, CCRA was requested to provide an advance tax ruling on the donation of wildlife art to a registered charity at a value in excess of the amount paid to purchase the artwork. CCRA indicated, on November 13, 1997, that it declined to provide any comment in so far as the concerns involved the determination of fair market value because it is CCRA's position that "tax savings depends on a sudden increase in FMV at [the] time of making [the] gift as compared to the actual costs a short time earlier" and "it is also a determination of fact as to whether the disposition is an adventure in the nature of trade or a capital disposition." Instead, CCRA only provided general comments in relation to the donation of capital property to a registered charity.

CCRA's Fact Sheet dated November 2002 concerning art-donation or art-flipping schemes indicates 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." This position was confirmed in CCRA's *Registered Charities Newsletter* No. 16 issued on October 9, 2003.

In this regard, Information Circular IC 01-1 specifically states the following:

If 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.

Registered Charities Newsletter No. 14 issued in the winter of 2003 indicates that “a series of test cases confirmed CCRA’s ability to disallow the inflated claims on donation receipts, and charities involved in these activities have been deregistered.” The *Newsletter* then indicates that the cases of 5 taxpayers were selected to go before the Tax Court of Canada as a test. At issue in these cases was “whether these individuals had made true donations, whether the value attributed to the works for donation purposes was their fair market value, and whether a penalty for gross negligence was appropriate”. In addition to finding that these individuals were only entitled to claim tax credits for the fair market value of the art works donated at 25% of the value claimed, the registered charities involved in those cases were deregistered. The art dealer involved also received a jail sentence when his case was brought before the Superior Court of Quebec.

The donation of items of “speculative value” was again brought up in the most recent *Registered Charities Newsletter* No. 16 issued on October 9, 2003, by explaining that such situations could involve “trading cards, comic books, and used cars, where a promoter facilitates the donations to the charity.” In *Registered Charities Newsletter* No. 16, CCRA also warns that the donation of such items could result in the charity not being able to meet its disbursement quota:

A charity should not lose sight of the fact that it is the amount for which the receipt is issued that is included in its disbursement quota requirement for the following year, even though the charity may in turn sell the property for an amount far below the amount for which the receipt was issued. Failure to meet the disbursement quota is grounds for us to revoke a charity’s registered status. In some cases, the charity gambles that the property will be worth at least the receipted amount at some future time.

In an article by Paul Waldie that appeared in *The Globe and Mail* on October 17, 2003 entitled, “Art dealer alleges tax harassment”, public attention was drawn to this problem with the following statement:

By law, charities must hand out 80 per cent of the donations they receive. If a charity received a donated piece of art appraised at \$1,000, the charity would have to disperse \$800 if the piece was sold within 10 years. However, the source [at a major charity] said in many cases organizations get far less than the appraised value for the art and they are forced to meet their disbursement quota through other funds.

In *Registered Charity Newsletter* No. 16, CCRA pointed out that charities are not obligated to either receive or receipt a gift if they choose not to:

Charities are reminded that they are not obliged under the *Income Tax Act* to issue official donation receipts for gifts; nor are they required to accept gifts. Before accepting gifts-in-kind, charities should ask themselves how the gift would allow them to further their charitable purposes.

In a speech given by Carl Juneau, a representative of CCRA, on November 12, 2003 at the *Church & the Law*TM Seminar hosted by Carter & Associates, he noted that tax shelter donation schemes can mean a significant fiscal loss to the Canadian government. Juneau advised that "...the bottom line is that these schemes are contrary to the spirit of giving and to charity. Charities should be in the spirit of, [the] business of generosity, not in the business of making money for others...If you have been approached by some of these promoters, be very careful. The Tax Avoidance Section is keeping close tabs on these promotions, and there will be legislative amendments to shut down this kind of practice".

On November 25, 2003, CCRA released a factsheet entitled "Tax Shelter Donation Arrangements", which provided numerous warnings and guidelines with respect to tax shelter donation schemes. CCRA defines these donation arrangements as involving:

...items sold, often in bulk, through a promoter who donates them to a registered charity which then issues a tax receipt for a considerably higher amount than was paid for the donated items. This type of donation scheme results in an income tax credit for the donor greater than the price paid, and may be disallowed by the Canada Customs and Revenue Agency (CCRA) at a later date.

An example of this – A tax shelter promoter presents an arrangement to you where you can buy – without taking possession of – a quantity of supplies at a bargain basement price. The promoter then arranges for this to be appraised and donated to a registered charity, which will then provide you with a tax receipt based on the appraised value. The tax receipt will be high

enough to produce a tax credit greater than the cost of the property plus any capital gains taxes resulting from the arrangement.

Considerable emphasis is given in the factsheet to the possibility of third-party civil penalties. As well, CCRA advises that the transactions described below may be challenged by CCRA:

- the advertised arrangements promise to sell items (such as art, software, or pharmaceuticals) to taxpayers to be donated immediately to selected charities for tax receipts that are much higher than what the person paid;
- the appraiser is not acting independently of the promoters or sellers of the arrangement or the charities involved;
- the fair market value seems too high;
- where the arrangement involves a loan where it's unlikely the person has to repay the loan because the lender's recourse to collect is limited, or the provision to settle the loan is by way of something other than cash payment from the taxpayer.

This factsheet can be accessed at <http://www.ccra-adrc.gc.ca/newsroom/factsheets/2003/nov/1125taxshelter-e.html>.

As well, on November 26, 2003, CCRA issued a summary policy entitled "Tax Shelters", which states that:

Under the *Income Tax Act*, a tax shelter includes any property or gifting arrangement for which a promoter represents that an investor can claim deductions or credits which equal or exceed the cost of the property less certain benefits within a four year period.

The summary policy can be accessed at <http://www.ccra-adrc.gc.ca/tax/charities/policy/csp/csp-t08-e.html>.

The Canadian Association of Gift Planners ("CAGP"), which represents approximately 1,200 gift planners in Canada, applauded CCRA's position on tax shelter donation programs. Malcolm Burrows, chair of government relations for the CAGP, was quoted in a December 1, 2003, Globe and Mail article by Paul Waldie entitled "Tax shelters being abused, charities say", as saying:

These so-called gifts do not make children healthier, save wildlife habitat, or put food in the mouths of the homeless... These arrangements are tax and profit motivated. A charitable gift by contrast has a cost to the donor. The promoters of these arrangements have no interest in helping charities achieve their charitable mission.

E. ANNOUNCEMENT OF PROPOSED AMENDMENTS TO THE *ITA*

On December 5, 2003, at 6:00 p.m., then Deputy Prime Minister and Minister of Finance, John Manley, announced that draft amendments to the tax shelter provisions of the *ITA* were being planned, which would limit tax benefits from charitable donations made under tax shelter donation arrangements. The Department of Finance was taking steps to curtail the scope of tax shelter donation arrangements after receiving public complaints and concerns with respect to donation promoters selling the “buy-low, donate-high” schemes that often provide the donor exceptionally high tax-benefits. The Department of Finance, like CCRA, was concerned that the government was losing substantial amounts of tax dollars when the taxpayer/donor was able to claim higher tax deductions than he/she was otherwise entitled to.

The proposed amendments provide that the fair market value of donated property which the donor acquired through a “gifting arrangement” will be “deemed” to be the lesser of the fair market value of the property and the cost of acquisition of the property by the donor, changing the value of the donations to the actual purchase price of the donated items rather than the appraised value. Where property is not acquired through a “gifting arrangement”, the above deeming provision for the fair market value will also apply if (1) the property was acquired by the donor less than three years prior to the date the donation is made, or (2) it is reasonable to conclude that, at the time the taxpayer acquired the property, the taxpayer expected to make a gift of the property. In addition, the deeming provision will not apply if the donation is made as a consequence of the donor’s death. This means that if a donor acquires property and donates the property within three year from the date of acquisition, then the fair market value of the property shall be the donor’s cost or adjusted cost base. Furthermore, regardless of when the donor acquired the property (even outside of the three-year limitation period), as long as it is “reasonable to conclude” that the donor had the intention to make a gift when the property was acquired, then the deeming provision would also apply. It is important to note that the above proposed amendments will not be applicable to gifts of inventory, publicly-traded securities, certified cultural property, ecological gifts, or real property situated in Canada. The said proposed amendments, if passed, will be retroactive to December 5, 2003. Further details brought about by the December 5, 2003 amendments will be set out in a future *Charity Law Bulletin*.

The Department of Finance's new release on tax shelters can be accessed at <http://www.fin.gc.ca/news03/03-061e.html>. The new draft amendments, which include amendments to other *ITA* provisions aside from tax shelters, can be reviewed at http://www.fin.gc.ca/drleg/03-061_1e.html. Further commentary on the proposed amendments will be discussed in future *Bulletins*.

F. ISSUES TO BE CONSIDERED

Where a charity has been involved in a tax shelter donation scheme prior to the announcement of proposed changes to the *ITA* provisions on December 5, 2003, the following are some of the issues that the charity may want to consider:

- ◆ A tax shelter registration does not in itself give the donation program any protection;
- ◆ There may be difficulties in establishing the fair market value of the goods being donated;
- ◆ The onus is on the charity to arrange a qualified appraisal of the donation, not on the promoter or the donor;
- ◆ There may be an issue of establishing donative intent by the donor;
- ◆ It is important to determine whether the donations are gifts of capital or inventory, determined preferably by means of an independent tax opinion;
- ◆ Possible third party penalties levied against a charity's for improper valuation of the fair market value of items donated;
- ◆ Potential assessment challenges of donors by CCRA;
- ◆ Potential problems in complying with a charity's disbursement quota;
- ◆ Due diligence requirements on the part of the charity in receiving, monitoring and disbursing products that are donated;
- ◆ The need for the charity to obtain independent legal advice;
- ◆ Where a legal defence fund is promised, questions of sufficiency need to be considered and whether it is available for the benefit of the charity as opposed to donors;
- ◆ Possible loss of charitable status by the charity; and
- ◆ Possible exposure of directors for personal liability to donors who are reassessed.

G. CONCLUSION

Given the numerous warnings by CCRA leading up to the announcement of proposed legislation by the Minister of Finance on December 5, 2003, charities that did become involved in tax shelter donation schemes may have cause for concern if CCRA decides to initiate an assessment of a charity that was involved in one of these schemes. In the future, charities and their boards of directors will want to be extremely cautious before becoming involved in any donation program that promises results to the donor or the charity that seem too good to be true, because they probably are.

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