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CHARITY LAW BULLETIN NO. 77

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JULY 18, 2005 DRAFT AMENDMENTS TO THE *INCOME TAX ACT* AFFECTING CHARITIES: PART II – OTHER CHANGES

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A. INTRODUCTION

On July 18, 2005, the Department of Finance (the "Department") again released legislative proposals (the "July 2005 Amendments") to amend the *Income Tax Act* (Canada) (the "Act"). The July 2005 proposal is a package of changes that consolidates and further amends previously proposed amendments introduced by the Department on December 20, 2002 (the "December 2002 Amendments"), December 5, 2003 (the "December 2003 Amendments") at 6 p.m. (Eastern Standard Time), and February 27, 2004 (the "February 2004 Amendments"), as well as amending provisions enacted by Bill C-33, *A Second Act to Implement Certain Provisions of the Budget Tabled in Parliament on March 23, 2004* that came into force on May 13, 2005.[1]

[1] The effect of these changes have been summarized in the following *Charity Law Bulletins* and paper, all of which are available on our website at www.charitylaw.ca, and readers are encouraged to refer to them for more detail:

- December 2002 Amendments – See *Charity Law Bulletin* No. 21, "Commentary on Draft Technical Amendments to the *Income Tax Act* Released on December 20, 2002 that Affect Charities," dated April 30, 2003.
- December 2003 Amendments – See *Charity Law Bulletin* No. 30, "Tax Shelter Donation Schemes," dated December 16, 2003; and *Charity Law Bulletin* No. 38, "December 5, 2003 *Income Tax Act* Amendments Affecting Charities," dated February 19, 2004.
- February 2004 Amendments – See *Charity Law Bulletin* No. 40, "February 27, 2004 Revised Draft Amendments to the *Income Tax Act* Affecting Charities," dated March 29, 2004.
- Bill C-33 – See paper by *New Disbursement Quota Rules Under Bill C-33*, M. Elena Hoffstein and Theresa L.M. Man, presented at the Canadian Bar Association /Ontario Bar Association 3rd National Symposium on Charity Law on May 6, 2005.

A number of the proposed changes will impact the operations of registered charities in Canada in a substantial way, including split-receipting, designation of charitable organizations and public foundations, revocation of charitable registrations, etc. These changes are summarized in a series of two *Charity Law Bulletins*. This *Bulletin* is Part II of the series, and summarizes the following changes:

- New definitions of charitable organizations and public foundations
- Enduring property
- Revocation of charitable registrations
- New qualified donees
- Expanded public information

Changes concerning the definition of gift and split-receipting are summarized in *Charity Law Bulletin* No. 76, available on our website at www.charitylaw.ca. The Department's news release indicates that comments regarding the July 2005 Amendments can be forwarded to the Tax Legislation Division of the Department by September 15, 2005.

B. NEW DEFINITIONS OF CHARITABLE ORGANIZATIONS AND PUBLIC FOUNDATIONS

The definitions of charitable organizations and public foundations in subsection 149.1(1) of the Act are proposed to be amended by replacing the "contribution" test with a new "control" test. The rationale for amending the definitions is to permit such charities to receive large gifts from donors without concern that they may be deemed to be private foundations. The changes were first introduced by the December 2002 Amendments and were included in the February 2004 Amendments with minor changes. The proposed amendments are further revised in the July 2005 Amendments. Once enacted, these amendments will generally become retroactive to January 1, 2000.

The Act currently provides that more than 50% of the directors, trustees, officers or similar officials of a charitable organization or public foundation must deal with each other and with each of the other directors, trustees, officers or similar officials at arm's length. In addition, not more than 50%[2] of a charitable organization's or a public foundation's capital may be contributed by a person or group of persons not dealing with each other at arm's length.[3] This is usually referred to as the "contribution" test.

[2] For some public foundations, the limit is 75%, depending on when they were registered.
[3] However, funds provided by the federal government, provincial governments, municipalities, other registered charities that are not private foundations, or non-profit organizations are exempt from this limitation.

As a result of inquiries from the public, the Explanatory Notes to the July 2005 Amendments (the "Explanatory Notes") indicate that the definitions are proposed to be amended so that a charity will not be disqualified as a charitable organization or public foundation solely because a person, or a group of persons not dealing with each other at arm's length, has contributed more than 50% of the charity's capital. However, such a person or group of persons is not permitted to control the charity "directly or indirectly in any manner whatever," nor may the person or members of the group represent more than 50% of the directors, trustees, officers or similar officials of the charity. The wording of the new definition indicates that upon a person or group of persons, who controls the charity, making the gifts contemplated in the definitions, then the charity would become a private foundation "at the particular time" that is immediately before the making of such gifts. This means that such a gift would cause the charity to become a private foundation immediately *before* the gift was made and the gift made by the person or the group of persons in question would be a gift made to a private foundation.

It appears that the application of the proposed control test is very complicated and possibly problematic. It is unclear how this test works in practice and what it means. Unfortunately, the meaning and application of the complexity of the control test has not been explained in the Explanatory Notes. For example, the revised wording in the July 2005 Amendments appears to prohibit control by a person who has made two consecutive contributions, i.e. a contribution greater than 50% of the charity's capital after having made that contribution at a particular time and a prior contribution greater than 50% of the charity's capital after that "last contribution." It is unclear whether the wording would imply that a donor who has made a one time donation that is greater than 50% of the charity's capital (without having made a prior contribution) is permissible, or that a donor may be able to avoid the application of this paragraph by making a small donation between the two large contributions contemplated in the definition. Furthermore, if a donor, who did not control the charity, made the contributions contemplated under the definitions and then subsequently acquired control of the charity, then it would appear that the charity would become a private foundation at the time when control is acquired. However, this has not been made clear in the proposed changes.

In addition, as a result of the prohibition against a person or related group of persons controlling the charity "directly or indirectly in any manner whatever" introduced by the "control" test, the general rules under the Act relating to "control" will become applicable. However, the practical implications of the application of

these rules in the charitable context are unclear, since these rules are premised upon application to commercial arrangements in a business context.[4] As such, it is important to carefully review these rules when establishing a charitable organization or a public foundation involving a major donor in order to ensure that the charity in question will not inadvertently be caught by these rules and be deemed to be a private foundation. As well, the structure of existing charities should also be reviewed in order to assess whether this new control test may have an undesirable effect.

Registered charities that find that they no longer fit under their current designation when applying the proposed "control test" may apply to the Minister of National Revenue (the "Minister") under subsection 149.1(6.3) of the Act to change their designation within 90 days after the July 2005 amendments having received Royal Assent. These registered charities will then be deemed to be registered as charitable organizations, public foundations, or private foundations, as the case may be, in the taxation year that the Minister specifies.

C. ENDURING PROPERTY

Bill C-33, which was enacted as *A Second Act to Implement Certain Provisions of the Budget Tabled in Parliament on March 23, 2004* that came into force on May 13, 2005, introduced a new definition for "enduring property" in subsection 149.1(1) of the Act for purposes of calculating the disbursement quota for charities. The English version of paragraph (d) in the definition of "enduring property" contains an erroneous cross reference to paragraph (b), which should have been paragraph (c). This error has been corrected by the July 2005 Amendments.

D. REVOCATION OF CHARITABLE REGISTRATIONS

Subsections 149.1(2), (3), and (4) of the Act provide for circumstances under which the charitable status of a charity may be revoked. The December 2002 Amendments proposed to amend subsections 149.1(2), (3), and (4) to provide that gifts made by a charity to a non qualified donee would become cause for revocation of the charitable status of the charity. These changes are included in the February 2004 Amendments and the July 2005 Amendments without change and would apply to gifts made by charities after December 20, 2002.

[4] See section 256 of the Act and CRA IT-64R4 dated August 14, 2001.

As a result of the possible loss of charitable status in making a disbursement to a non qualified donee, charities will need to be more cautious than ever when making disbursements and ensure that all disbursements are either made in the course of carrying out their charitable activities or to qualified donees and that no disbursements are made to non qualified donees unless there is an agency, joint venture or partnership agreement in place in accordance with the requirements of Canada Revenue Agency ("CRA").

E. NEW QUALIFIED DONEES

Sections 110.1 and 118.1 of the Act are proposed to be amended by expanding the list of "qualified donees" as defined in subsection 149.1(1) to include municipal or public bodies performing a function of government in Canada. This proposed amendment was first introduced by the February 2004 Amendments and is included in the July 2005 Amendments without further changes.

The Tax Court of Canada, in the case *Otineka Development Corporation Limited and 72902 Manitoba Limited* v. *The Queen*,[5] held that an entity could be considered a municipality for the purpose of paragraph 149(1)(d.5) on the basis of the functions it exercised. However, the Quebec Court of Appeal in *Tawich Development Corporation* v. *Deputy Minister of Revenue of Quebec* ("Tawich") [6] held that an entity could not attain the status of a municipality by exercising municipal functions, but only by statute, letters patent or order. In response to the Quebec Court of Appeal decision in Tawich, the definition of qualified donee is proposed to be expanded to include municipal or public bodies performing a function of government in Canada.

F. EXPANDED PUBLIC INFORMATION

Paragraph 149.1(15)(b) of the Act currently permits the Minister to make available to the public certain information concerning registered charities, including a list of all registered charities, indicating their names, location, registration number, date of registration, and effective date of revocation of charitable status where applicable. Pursuant to the December 2002 Amendments, this authority to disclose information to the public is expanded to apply to Canadian amateur athletic associations in order to provide more transparency to the operations of these entities to the public. This amendment was included in the February 2004 Amendments and the July 2005 Amendments without further changes.

[5] 94 D.T.C. 1234, [1994] 1 C.T.C. 2424.
[6] 2001 D.T.C. 5144.

G. CONCLUSION

The July 2005 Amendments, once enacted, will bring sweeping changes that affect charities in many ways. It is important that charities and their advisors become familiar with these proposed changes in order to comply with the same. These new rules summarised in this Bulletin include the following:

- how and when does the control test apply;
- what does "control" mean;
- what does "arm's length" mean and how does it apply to the control test;
- is the current structure of the charity affected by the new control test;
- what should the charity be aware of if a donor wishes to make a major donation to the charity; and
- what should the charity be aware of if it wishes to make a disbursement or payment to a non qualified donee, such as entering into an agency, joint venture or partnership relationship with the non qualified donee in accordance with the requirement of CRA.

It is also important for charities to be aware that the new control test generally applies retroactively from January 1, 2000, and the changes to subsections 149.1(2), (3), and (4) concerning revocation of charities apply to gifts made by charities after December 20, 2002.

Since there are many areas where the July 2005 Amendments are not clear, it is hoped that these grey areas will be clarified either by remedial amendments to the Act or by CRA providing the charitable sector with administrative guidelines on how these statutory provisions will be interpreted by CRA and how charities may be required to comply with them.

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