
FEDERAL BUDGET 2008 HIGHLIGHTS FOR CHARITIES

*By Theresa L. M. Man, B.Sc., M. Mus., LL.B., LL.M.
and Terrance S. Carter, B.A., LL.B. and Trade-mark Agent
Assisted by Derek B. M. Ross, LL.B.*

A. INTRODUCTION

The Federal Budget released on February 26, 2008, proposes a number of measures which will impact registered charities and their donors. The Standing Committee on Finance, in its report summarizing the results of its pre-budget consultations and recommendations made in advance of the 2008 Budget, recommended that “the federal government amend the *Income Tax Act* (Canada) (the “Act”) in order to enhance incentives for charitable giving.” The federal government’s response in its 2008 Budget is the proposal of a few additional tax incentives with respect to donations of securities and gifts of medicine to registered charities. In addition, the 2008 Budget modifies the excess business holding rules for private foundations introduced in the 2007 Budget, and promises significant funding to the Charities Directorate of the Canada Revenue Agency to combat terrorist financing.

B. EXEMPTION OF CAPITAL GAINS TAX FOR DONATIONS OF EXCHANGEABLE SECURITIES

In the 2006 and 2007 Budgets, the federal government eliminated the capital gains tax on gifts of publicly listed securities to registered charities. This exemption, however, does not apply to situations where a person exchanges unlisted securities into publicly listed securities in order to make a donation to charities, because the gain arose on the exchange and not on the gift.

The 2008 Budget proposes to extend the exemption to donations of unlisted securities that are exchanged for publicly traded securities before being gifted to a registered charity. This measure will apply to donations made on or after February 26, 2008.

In order for such a gift to qualify for the tax exemption, the unlisted securities must have included, at the time they were issued, a condition allowing the holder to exchange them for the publicly traded securities. In addition, the publicly traded securities acquired on the exchange must be the only consideration received on the exchange and donated to a registered charity within 30 days of the exchange. The 2008 Budget also provides that the unlisted securities may be shares or partnership interests (other than prescribed interests in a partnership). Where the exchangeable securities are partnership interests, special rules will apply to ensure that only capital gains that reflect economic appreciation of the partnership interests are exempted, and not gains that arise because of various reductions to the adjusted cost base of partnership interests.

C. ADJUSTMENT TO EXCESS BUSINESS HOLDINGS RULES FOR PRIVATE FOUNDATIONS

In the 2007 Budget, the government introduced an excess business holdings regime to address concerns that persons connected with a private foundation, by virtue of their and the foundation's combined shareholdings, may be able to exercise undue influence for their own benefit. The regime places limits on foundation shareholdings that take into account the holdings of persons not dealing at arm's length with the foundation, and requires private foundations to divest such shares in excess of the specified limit. The excess business holdings rules are contained in Bill C-28, which received Royal Assent on December 14, 2007 and enacted as *Budget and Economic Statement Implementation Act, 2007*, c.35.¹

Generally, a private foundation can hold up to 2% of any class of shares in a corporation without being subject to any divestiture requirements. Where a foundation holds more than the 2% limit and the total shareholdings by the foundation and relevant persons (i.e. generally persons not dealing at arm's length with the foundation) together exceed 20% of a class of shares, the foundation is required to divest itself of enough shares such that it meets the 2% limit or it and relevant persons together do not exceed the 20% limit. Foundations are also required to comply with certain disclosure requirements. Transitional rules allow foundations to divest themselves, over a period of from five to 20 years, of excess corporate shares held on

¹ The excess business holdings rules were implemented by the insertion of various definitions in subsection 149.1(1) of the Act, amendments to paragraph 149.1(4)(c), paragraph 149.1(12)(a) and subsection 149.1(15) of the Act, as well as the insertion of new section 149.2 and subsection 188.1(3.1) into the Act.

March 18, 2007. There is no obligation to divest entrusted shares, i.e. shares donated before March 19, 2007 and subject to a condition that they be retained by the foundation. The same provisions apply 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 that included such a condition and was not amended after that date. However, entrusted shares are taken into account in determining the application of the excess business holdings rules.

As a result of Finance's continuing consultation with private foundations after the enactment of the excess business holdings rules in December 2007, the 2008 Budget proposes a number of changes to these rules, including the exemption of the application of these rules to holdings of certain unlisted shares, rules that apply to entrusted shares and the substitution of shares. These new changes will apply to taxation years that begin on or after March 19, 2007.

1. Exemption for unlisted shares

The current excess business holdings rules apply to shareholdings of both publicly listed and unlisted shares. The 2008 Budget proposes to exempt certain unlisted shares (i.e. those that are not listed on a designated stock exchange) that were held on March 18, 2007 from the divestiture requirements of the excess business holdings rules. The rationale for this exemption is to relieve foundations from the burden of having to find buyers for unlisted shares which often represent unique assets with no ready market. The 2008 Budget proposes that unlisted shares in a corporation held on March 18, 2007 by a foundation be considered "exempt" unless:

- the foundation owns, indirectly as a result of that shareholding in that corporation, an interest in listed shares of a class of another corporation;
- that indirect interest is held through a "controlled corporation", which is a corporation controlled by the foundation, by a relevant person, by a group of relevant persons, or by the foundation together with a relevant person or such a group;
- if the foundation had instead owned those listed shares itself, it would, together with relevant persons, hold more than 20% of those listed shares; and

- the foundation, together with all controlled corporations, holds more than 2% of those listed shares.

If a share becomes or ceases to be exempt under these conditions at the end of *any* taxation year, it will be subject to the existing transitional rules from that time on, but it will not affect the foundation's divestment obligation for any previous taxation year. If the share meets these conditions again, it will once again become exempt.

Other unlisted shares held on March 18, 2007 will continue to be subject to the current excess business holdings rules.

2. Shares held through a trust on March 18, 2007

A trust may be considered a relevant person in respect of a private foundation. The 2008 Budget proposes new rules with respect to shares held on March 18, 2007 by such a "non arm's-length" trust. A foundation will be deemed to own such shares, in proportion to the value of the foundation's interest in the trust, where (1) the foundation is the sole trustee of the trust or (2) the foundation is a "majority interest beneficiary" (as currently defined in the Act) of the trust and a majority of the trustees of the trust consist of the foundation and relevant persons.

Also, the 2008 Budget provides that, where such a trust holds entrusted shares or exempt shares, the excess business holdings rules will respect the terms under which the trust holds the actual shares. The example provided in the 2008 Budget explains that shares held by the trust that are subject to a condition that they may not be disposed of will not, by themselves, result in a divestment obligation to the foundation.

This measure will apply in respect of private foundations' divestment obligations for taxation years that begin on or after February 26, 2008.

3. Substituted shares

The 2008 Budget also introduces the concept of "substituted shares." Substituted shares will generally be shares acquired by a person in the context of a corporate reorganization, in exchange for other

shares (i.e. shares acquired in the course of a rollover transaction under sections 51, 85.1(1)(a)(i), 86 or 87 of the Act). Substituted shares will be treated the same as the shares for which they were exchanged for purposes of applying the exemption from the excess business holdings rules (where the exchanged shares were exempt shares or entrusted shares), and the timing of any applicable divestment obligations (including those associated with transitional relief).

4. Entrusted shares

Under the existing excess business holdings rules, if a foundation holds more than 2% of non-exempt outstanding shares of a given class, and the foundation and relevant persons together hold more than 20% of that class, a divestment will be required and penalties will be imposed if the divestment does not occur within the time periods specified by the rules.

This divestment obligation is an obligation upon the foundation. However, in certain circumstances where a foundation holds entrusted shares, the existing rules could impose a divestment obligation that the foundation cannot itself meet (because the foundation is prohibited under the terms of the trust to divest of those shares), implying that a divestment will need to be made by a relevant person. The 2008 Budget proposes an amendment to correct this “ambiguity” and make clear that entrusted shares need not be divested in these circumstances.

5. Avoidance transactions involving trusts

The excess business holdings regime includes anti-avoidance rules that address “attempts by private foundations to circumvent the regime’s reporting or divestment obligations”.

The 2008 Budget proposes to extend these anti-avoidance provisions to certain inappropriate uses of trusts to avoid the application of the excess business holdings rules. In particular, the provisions will apply to circumstances in which it may reasonably be considered that one of the purposes of the establishment of a trust is to hold or acquire shares or other interests or rights in one or more corporations that would, if they were held by a beneficiary of the trust that is a private foundation or a relevant person, result in a divestment obligation to the foundation. In such a case, the foundation or relevant person will be deemed to hold those shares in the corporation that reflect the value of their

indirect interest in the corporation. This anti-avoidance provision will apply in respect of private foundations' divestment obligations for taxation years that begin on or after February 26, 2008.

D. GIFTS OF MEDICINES

The 2007 Budget introduced a special tax incentive for corporations that make donations of medicine to registered charities for use in the developing world. This incentive allows a corporation that makes a donation from its inventory to claim an additional deduction (in addition to the charitable deduction equal to the fair market value of the donated medicine) equal to the lesser of 50% of the amount by which the fair market value of the donated medicine exceeds its cost, and the costs of the donated medicine.²

Currently, this tax deduction is only available when the donee is a registered charity that has received a disbursement under a program of the Canadian International Development Agency (CIDA) and the gift is made in respect of activities of the charity outside of Canada. The 2008 Budget proposes to change the definition of an eligible charity for the purpose of this tax deduction. An eligible charity will be a registered charity that meets certain conditions prescribed by regulation. The determination of whether a charity meets those conditions is to be made by the Minister of International Cooperation (or, in the event that no such Minister is appointed, the Minister responsible for CIDA will make such a determination). The 2008 Budget indicates that the main purpose of these conditions will be to ensure that eligible charities:

- act in a manner consistent with the principles and objectives of the World Health Organization Guidelines for Drug Donations;
- have expertise in delivering medical donations to the developing world; and
- implement appropriate policies and practices with respect to the delivery of international development assistance.

The 2008 Budget also proposes that, in order for gifts of medicine to qualify for this deduction, they must be donated at least six months prior to their expiration date.

These changes will apply to eligible donations of medicines made on or after July 1, 2008.

² See subsections 110.1(1)(a.1) and 110.1(8) of the Act.

E. CHARITIES AND ANTI-TERRORISM

In the 2008 Budget, the federal government reiterates its commitment to assess the need for further legislative measures to protect the integrity of Canada's financial system. As part of this commitment, the government has promised to take action in response to the international Financial Action Task Force's upcoming evaluation of Canada's anti-money laundering and anti-terrorism-financing regime. In addition, in order to "bolster existing capacities to combat terrorist financing," the 2008 Budget promises funding of \$10 million over two years to the Canadian Security Intelligence Service and the Canada Revenue Agency's Charities Directorate. This will be concerning for charities operating outside of Canada, as their operations will obviously come under greater scrutiny by the federal government.

F. CONCLUSION

The impact of the 2008 Budget upon charities is primarily in the area of amendments to the Act introduced to extend tax incentives in certain limited situations, as well as introducing adjustments to the excess business holdings rules that required a number of technical amendments. Although the 2008 Budget does not address everything that the charitable sector was looking for (such as an extension of the exemption of capital gains tax for gifts of unlisted shares), at least the extension of the existing incentives and the introduction of technical amendments to the complex excess business holdings rules will address some of the unintended inequities resulting from the 2007 Budget.