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## **BUDGET 2011 WILL HAVE BROAD IMPACT ON THE CHARITABLE SECTOR**

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### **A. INTRODUCTION**

Terrance S. Carter

The 2011 federal Budget introduced on March 22, 2011 (the “Budget”)<sup>1</sup> proposes sweeping changes to the regulatory regime affecting registered charities and qualified donees, and in particular Canadian Registered Amateur Athletic Associations (RCAAs), as summarised below in this *Charity Law Bulletin*. The stated purpose of the Budget proposals concerning the regulation of registered charities and other qualified donees is to equip Canada Revenue Agency (“CRA”) as the administrator of the tax system related to the charitable sector with “an effective set of compliance tools to safeguard the donation of Canadian taxpayers and act against any organization that does not follow the rules.” In doing so, the government has targeted areas of perceived weakness in the regulation of charities and qualified donees, with a specific focus on RCAAs, that the government believes requires either more transparency or more equality in treatment, as well as a focus on closing potential tax loop holes, such as the current “double-dipping” involving gifts of flow through shares.

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<sup>1</sup> The Budget details are available in *The Budget Plan* available online at <http://www.budget.gc.ca/2011/plan/toc-tdm-eng.html>.

Because of the recent dissolution of Parliament, it will be important to carefully monitor its impact on the proposed provisions detailed in the Budget. Since most of the proposals reflect technical amendments to the *Income Tax Act* (“ITA”) that the Budget states are needed to better regulate the charitable sector (and which likely originated from within CRA or the Department of Finance), there is a good chance that most, if not all of the proposals, will reappear in a future federal budget or as part of a separate bill containing technical amendments to the ITA. It remains unclear, however, whether CRA will administratively treat the Budget proposals as already being in effect notwithstanding the subsequent dissolution of parliament and if so from what date. Some of the proposals, like those dealing with flow through shares, have a stated effective date of the Budget date, whereas other proposals, such as those dealing with new governance requirements, have an effective date of the later of January 1, 2012 or the date of Royal Assent of the enacting legislation. As such, there remains uncertainty concerning when the Budget provisions will take effect, if at all. However, in the meantime, there should be opportunities for the charitable sector to enter into a dialogue with CRA and the Department of Finance concerning the terms and the implementation of the Budget proposals, including some of the unintended consequences that will no doubt come to light over the next few months after the charitable sector has had an opportunity to thoroughly consider the Budget proposals.

What follows in this *Charity Law Bulletin* are a series of brief overviews of the various proposals contained in the Budget in the order that they appear within Annex 3 of *The Budget Plan*.

## **B. NEW REGULATORY REGIME FOR QUALIFIED DONEES**

Theresa L.M. Man

Qualified donees may issue official donation receipts for gifts. “Qualified donees” is a term defined in the ITA to include various types of entities, the largest group of which are registered charities. To safeguard the tax system from abuse and to ensure compliance by those organizations given the privilege of issuing official donation receipts, the Budget proposes to extend to the following types of qualified donees certain regulatory requirements that currently apply to registered charities in the interest of fairness and consistency:

- registered Canadian amateur athletic associations (RCAAs);
- municipalities in Canada;

- municipal and public bodies performing a function of government in Canada (these entities are proposed to be added to the list of qualified donees and were previously included in the proposed technical amendments to the ITA released on July 16, 2010);
- housing corporations in Canada constituted exclusively to provide low-cost housing for the aged;
- prescribed universities outside of Canada, the student body of which ordinarily includes students from Canada; and
- certain other charitable organizations outside of Canada that have received a gift from Her Majesty in right of Canada.

These new requirements will be effective on or after the later of January 1, 2012 and the date of Royal Assent to the enacting legislation. The extension of these new requirements will not apply to the balance of qualified donees, i.e., the Government of Canada, provincial and territorial governments in Canada, and the United Nations and its agencies. Registered national arts service organizations are deemed to be “registered charities” and are therefore currently subject to the same requirements that apply to registered charities.

The proposed new requirements to apply to the above list of qualified donees are:

(1) Qualified donees will be identified in a publicly available list maintained by CRA. This will enable the public to determine which organizations may issue an official donation receipts and registered charities to determine whether an organization is a qualified donee for grant-making purposes. Technical amendments to the ITA released on July 16, 2010 already proposed to authorize CRA to release the name, registration number and other relevant information with respect to RCAAAs. As well, a list of prescribed universities is already published in Schedule VIII of the *Income Tax Regulations* and CRA already publishes a list of charitable organizations outside of Canada that have received a gift from Her Majesty in right of Canada.

(2) If a qualified donee does not issue donation receipts in accordance with the ITA and its regulations, it may be subject to suspension of receipting privileges or revocation of qualified donee status.

(3) Monetary penalties associated with improper issuance of receipts that currently apply to registered charities will be extended to RCAAAs.

(4) Qualified donees will be required to maintain proper books and records and provide access to those books and records to CRA when requested. If a qualified donee fails to do so, CRA may suspend its receipting privileges or revoke its qualified donee status.

(5) Monetary penalties associated with failing to file an information return that apply to registered charities will be extended to RCAAAs.

As well, the Budget proposes to extend the following additional regulatory requirements (which currently apply to registered charities) to RCAAAs:

(1) Exclusivity of Purpose and Function - The Budget proposes that RCAAAs be required to have the promotion of amateur athletics in Canada on a nation-wide basis as their *exclusive* purpose and exclusive function, rather than their primary purpose and primary function. These changes are not intended to prevent RCAAAs from staging or engaging in international events and competitions. RCAAAs will also be permitted to carry on related business activities, such as selling merchandise related to their sport, and to engage in limited non-partisan political activities. Breach of these requirements will result in the RCAA possibly being subject to monetary penalties, suspension of receipting privileges, or revocation.

(2) Undue Benefits - The Budget proposes that if an RCAA provides an undue benefit to any person (e.g. excessive compensation to staff, professional fundraiser or any individual or company with whom it does business), it may be subject to monetary penalties, suspension of its receipting privileges, or revocation.

(3) Public Access to Information - The Budget proposes to authorize CRA to make available to the public certain information and documents in respect of RCAAAs, in the same manner as applies to registered charities, e.g. governing documents, annual information returns, applications for registration and the names of directors.

## **C. NEW GOVERNANCE REGIME FOR REGISTERED CHARITIES AND RCAAAS**

Terrance S. Carter

The Budget identifies a CRA concern that there is a recurring problem with applications for charitable status being submitted by individuals who have been involved with other charities and RCAAAs that have had

their status revoked for serious non-compliance, such as issuing fraudulent receipts, or have a criminal record of offences involving a breach of public trust, such as fraud or misappropriation. Currently, CRA does not have the ability to refuse to register or revoke the status of a registered charity or RCAA based upon any of these grounds.

As a result, the Budget proposes to give CRA unprecedented new authority over the governance of registered charities and RCAAs. In this regard, the Budget gives CRA the discretion to refuse or to revoke the registration of a charity or a RCAA or to suspend its authority to issue official donation receipts, if a member of the board of directors, a trustee, officer or equivalent official, or any individual who otherwise controls or manages the operation of the charity or RCAA:

- has been found guilty of a criminal offence in Canada or an offence outside of Canada that, if committed in Canada, would constitute a criminal offence under Canadian law, relating to financial dishonesty (including tax evasion, theft or fraud), or any other criminal offence that is relevant to the operation of the organization, for which he or she has not received a pardon (“relevant criminal offence”);
- has been found guilty of an offence in Canada within the past five years, or an offence committed outside Canada within the past five years that, if committed in Canada, would constitute an offence under Canadian law, relating to financial dishonesty (including offences under charitable fundraising legislation, convictions for misrepresentation under consumer protection legislation or convictions under securities legislation) or any other offence that is relevant to the operation of the charity or RCAA (“relevant offence”);
- was a member of the board of directors, a trustee, officer or equivalent official, or an individual who otherwise controlled or managed the operation of a charity or RCAA during a period in which the organization engaged in serious non-compliance for which its registration has been revoked within the past five years; or
- was at any time a promoter (as defined by section 237.1 of the ITA) of a gifting arrangement or other tax shelter in which a charity or RCAA participated and the registration the charity or RCAA has been revoked within the past five years for reasons that included or were related to its participation.

All of these individuals are collectively defined in the Budget as “ineligible individuals.” These measures will apply on or after the later of January 1, 2012, or Royal Assent to the enacting legislation.

The Budget states that CRA will look at the “particular circumstances” of a charity or RCAA in determining whether CRA’s new authority to refuse or revoke registration as a charity or RCAA, or suspend the ability to issue official donation receipts will apply, but does not state what those circumstances are except to say that if there is involvement of an “ineligible individual” with an organization, CRA will take into account whether “appropriate safeguards have been instituted to address any potential concerns.” However, there is no explanation of what these safeguards might be.

The practical question that arises is what sort of due diligence will a charity or a RCAA be required to undertake to ensure that an “ineligible individual” does not become involved or continue to be involved as a board member, trustee, officer or equivalent official, or one who controls or manages the organization. Even though the Budget indicates that a charity or RCAA will not be required to conduct background checks, a charity will likely want a prospective board member or officer to complete some type of questionnaire to demonstrate due diligence. However, is the questionnaire to be done on a yearly or just when the person joins the organization? As well, how extensive does the questionnaire need to be, in particular given the breadth of the definition of “relevant offences” referred to in the Budget, since such offences will extend well beyond criminal code provisions to include, for instance, violation of provincial fundraising and securities legislation within the last five years, as well as similar legislation outside of Canada? These are all unanswered questions which will need to be addressed in discussions between CRA and the charitable sector leading up to the implementation of the provisions of the Budget, whenever that is.

#### **D. RECOVERY OF TAX ASSISTANCE FOR RETURNED GIFTS**

Ryan M. Prendergast

The Budget provides clarification with respect to what happens when a charity returns a donation as it relates to compliance with the ITA. In this regard, the following synopsis of the Budget provisions relating to the

return of a gift under the ITA do not address the other potential liabilities that a charity could still face at common law were it to return a gift.<sup>2</sup>

Prior to the Budget, only brief guidance was provided by CRA with respect to the situation of a return of a gift to a taxpayer. While CRA has a page on its website titled “Returning a Gift to a Donor,”<sup>3</sup> the page generally recommends that legal counsel be contacted by the charity should the situation arise. However, measures proposed in the Budget will now clarify the tax consequences where a gift is returned to a donor and expands CRA’s ability to reassess those donors. The Budget indicates that these measures will apply in respect of gifts or property returned on or after the date of the Budget.

The Budget permits CRA to reassess a taxpayer outside the normal reassessment period and disallow a taxpayer’s claim for a credit or deduction in any situation where the gifted property is returned to a donor in order to ensure “that tax assistance is not improperly retained.” In this regard, the Minister of National Revenue will have the authority to reassess a tax return of any person where the reassessment can reasonably be regarded as relating to a return of property from a qualified donee to the donor. In addition, where a qualified donee issued an official donation receipt in respect of a gift of property and subsequently returns that property to the donor, if the value of that returned property is greater than \$50, the qualified donee must issue a revised donation receipt with prescribed information and file a copy with CRA.

With respect to the return of donated property, the Budget provides rules which address various scenarios that could occur on the return of a gift, which can be summarized as follows:

- 1. If the transfer of the original property was a gift, the person is deemed not to have made a gift of the original property nor to have disposed of the property at the time the gift was made. This provision cancels the gift from having occurred at the time the original property was given, thereby disentitling the donor from having received a tax receipt for income tax purposes in the first place.*
- 2. If the transfer of the original property was not a gift, for greater certainty, the person is considered not to have disposed of the original property at the time that it was provided to the qualified donee. While this*

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<sup>2</sup> See Ryan M. Prendergast in “Looking a Gift Horse in the Mouth: What to Do With “Bad” Donations” *Charity Law Bulletin* No. 227 (September 29, 2010). Available online at: <http://www.carters.ca/pub/bulletin/charity/2010/chylb227.pdf>.

<sup>3</sup> Canada Revenue Agency, “Return of a Gift to a Donor” at <http://www.cra-arc.gc.ca/chrts-gvng/chrts/prtng/gfts/rtrngng-eng.html>. Last updated March 26, 2008.

provision would seem somewhat obvious, it appears to capture transfers of property which were not gifts to begin with and may have been receipted improperly. Therefore, the Minister would then be able to reassess the donor if the charity returned the property.

*3. If the returned property is identical to the original property, the returned property is deemed to be the original property.* While a qualified donee which receives original property which was transferred to it as an in-kind gift can likely return the same original property to the donor, it is unlikely that a charity can return the same funds it might receive as a cash gift to the donor. In this regard, this provision will deem the return of “identical” property, which could mean the same sum of money that was given, as the same property which the qualified donee originally received from the donor.

*4. If the returned property is not the same property or identical property, the person is deemed to have disposed of the original property at the time that the person acquires the returned property.* This provision would seem to mean that where the property that is returned to the donor is not the same or identical property, the donor will incur a deemed disposition on the original property that was given upon receipt of the returned property. This may occur where the qualified donee returns funds which are in lieu of an in-kind gift which the donor originally gifted to the qualified donee.

A qualified donee faced with the return of a gift will therefore want to give consideration to the above rules depending on the situation and the property donated, as it may result in a different outcome for the donor depending upon the nature of the original gift and what property is being returned to the donor.

## **E. GIFTS OF NON-QUALIFYING SECURITIES**

Karen J. Cooper

The Budget proposes that the rules regarding donations by a taxpayer of a non-qualifying security (“NQS”) to a registered charity be modified, effective for dispositions made by recipient organizations on or after the date of the Budget. A NQS is defined to include a share, a debt obligation or other security issued by a taxpayer or by a person not dealing at arm’s length with a taxpayer, but does not include publicly listed securities and deposit obligations of financial institutions. These rules previously applied only to donations of NQS to private foundations and other registered charities not at arm’s length to the donor and have been extended by the Budget to apply to all gifts of NQS to all registered charities. Also, the tax recognition will

now be deferred until the recipient charity disposes of the NQS for consideration that is not another NQS of any person. If the NQS is not disposed of by the charity within the five-year period following the date of the gift, there will be no tax recognition of the gift.

The Budget has also proposed new anti-avoidance rules to catch situations whereby, through a series of transactions, a donor avoids the application of the above NQS rules, but at the end of the series of transactions the charity receives a NQS.

## **F. GRANTING OF OPTIONS TO QUALIFIED DONEES**

Karen J. Cooper

Effective for gifts made on or after March 22, 2010, the Budget proposes to delay the recognition of a gift to a qualified donee of an option to acquire property. Previously, where a donor granted an option to purchase property to a qualified donee, the gift was recognized on the date of the gift for the fair market value of the option and a receipt could be issued immediately. The Budget proposes to delay this until the option is exercised by the qualified donee, eg. the property is purchased. The new rules are designed to coincide with the proposed split-receipting rules, in particular the proposed rule providing that where an advantage associated with a gift exceeds 80 per cent of the value of the property transferred, there is no gift. As such, where the total of any consideration paid for either the option or the property by the qualified donee exceeds 80 per cent of the fair market value of the underlying property, the exercise of the option will not be considered to be a gift unless the donor can establish that the granting of the option and the exercise thereof was made with the intention of making a gift to a qualified donee. The proposed provisions also deal with the value of the gift for receipting purposes when the option is exercised, and when the option is disposed of by the qualified donee prior to being exercised, the proceeds of disposition to the donor and the value of the gift for receipting purposes.

## **G. DONATIONS OF FLOW-THRU SHARES**

Karen J. Cooper

Since the elimination by the 2006 Budget of the tax on capital gains accruing on donations of publicly-traded securities to registered charities, donation tax shelter structures involving gifts of flow-thru shares (“FTS”)

have increased substantially.<sup>4</sup> Generally, a taxpayer can acquire FTS issued by corporations in the oil and gas, mining and renewable energy fields and claim the benefit of “flow-thru” income tax deductions of certain expenses. As these deductions are claimed, the adjusted cost base (“ACB”) of the shares is reduced (usually to nil) such that when the FTS are sold, the full amount of the sale proceeds are taxed as a capital gain. If, instead, the FTS are donated to charity, the taxpayer gets the benefit of a tax credit or deduction based on the value of the share at the time of the donation and can also claim the benefit of the exemption from capital gains tax on the disposition. In many circumstances, the combined effect of the deduction of the “flow-thru” expenses, the elimination of the capital gains tax, and the charitable donation deduction or credit substantially reduces or virtually eliminates the after-tax cost of making a charitable donation.

The 2011 Budget proposes to limit the availability of the exemption from tax on capital gains where FTS are donated to a qualified donee. Effective on or after the Budget date, the exemption from tax on the capital gain that arises from the donation of FTS will only apply to the extent that the cumulative capital gains in respect of the gift exceeds the original cost of the FTS. This will have the effect of substantially reducing the tax benefits of a gift of FTS so that they are generally no more attractive an option than any other gift of shares or cash. The Budget also contains anti-avoidance provisions that are intended to ensure taxpayers are not able to structure around these changes.

## **H. SUPPORTING SOCIAL PARTNERSHIPS**

Theresa L.M. Man

The Budget recognizes that some groups, such as the homeless, persistently unemployed, and at-risk youth, face complex and continual social challenges and that often the best solutions to tackling these difficult problems are found locally. Citizens, businesses, charities and other groups, such as the Canadian Task Force on Social Finance, are working together to develop ways to address local challenges. The Budget states that the Government will encourage the development of government/community partnerships enabling communities to tackle local challenges and testing new approaches to improve performance. Details are to be announced by the Minister of Human Resources and Skills Development at a later time.

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<sup>4</sup> See *Charity Law Bulletin No. 116* (available online at <http://www.carters.ca/pub/bulletin/charity/2007/chylb116.pdf>) for a detailed description of the history and tax consequences prior to this Budget.

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