CASES AND COMMENTS

HARSHMAN ESTATE v M.N.R.
Stuart D. Thom

A close analysis of the reasons for judgment in the appeal of the Executors of the estate of H. H. Harshman from an estate tax assessment can, without too great effort, lead one to think that the decision in favour of the estate was a triumph of the public good over narrow legalisms under The Estate Tax Act. A similar outcome can be discerned in earlier estate tax apeals. It is agreeable that the courts will give effect to some inner feeling that charitable intentions of testators should not be frustrated by over-emphasis on the language of the statutes. The difficulty this benign approach poses for those advising prospective litigants in this area of the law is the uncertainty that a court tomorrow will follow a trend set by the courts of yesterday. These remarks should in no way be regarded as suggesting that courts do not decide cases according to the law. It is rather that the law is declared to be that which will put the interests of deserving beneficiaries ahead of those of the revenue when there are ambiguities or lucanae in the black letter of the legislation or the concepts of the jurisprudence. In the Harshman case the resolution of the issue against the position taken by the Department of National Revenue was sufficiently well founded that no appeal followed the Exchequer Court decision.

The background of the appeal was (to paraphrase the words of the judgment) that the late Mr. Harshman was interested in assisting needy students to continue with their education so that they might play a more useful part in Canadian society and also as a means of countering the "brain drain" to the United States. These exemplary motives had found expression during the lifetime of the deceased by gifts to a corporation known as the Institute of Citizenship and to the MacDonald Institute, as it then was, in Guelph and to The Harshman Foundation. The last named donee was constituted by way of a memorandum of trust on September 15th, 1963 and, judging by the amount of tax involved, was the recipient of a substantial gift during Mr. Harshman's lifetime. He also left to it the residue of his estate – itself a considerable sum. He died in October, 1964.

The Department of National Revenue would appear to have claimed to tax all gifts to the Foundation, presumably under paragraphs (c) and (a), respectively, of Section 3 (1). The estate claimed exemption from tax under Section 7 (1) (d) (i) which, as it stood after being amended in 1960, read as follows:

"(d) the value of any gift made by the deceased whether during his lifetime or by his will, where such gift can be established to have been absolute and indefeasible, to

(i) any organization in Canada, that, at the time of the making of the gift and of the death of the deceased, was an organization constituted exclusively for charitable purposes, all or substantially all of the re-

sources of which, if any, were devoted to charitable activities carried on or to be carried on by it or to the making of gifts to other such organizations in Canada all or substantially all of the resources of which were so devoted, and no part of the resources of which was payable to or otherwise available for the benefit of any proprietor, member of shareholder thereof,"

The thrust of the Minister's argument denying the exemption can more readily be comprehended if the foregoing provision is compared with the original language which was:

"(d) the value of any gift made by the deceased whether during his lifetime or by his will, where such gift can be established to have been absolute, to

(i) any organization in Canada that, at the time of the making of the gift, was a charitable organization operated exclusively as such and not for the benefit, gain or profit of any proprietor, member or shareholder thereof,"

It will be noted that the exempt donee was transformed from a "charitable organization operated exclusively as such" to an "organization constituted exclusively for charitable purposes" where such organization was either a charitable organization in its own right or made gifts to other organizations whose resources were devoted to charitable purposes.

The Minister's arguments as set out in the reasons for judgment constituted a two-stage attack on the appellants' claim for exemption. These arguments are effectively and completely stated in the following excerpt from the judgment which quotes from paragraph 9 of the Minister's Reply to the Notice of Appeal:

"9. The Respondent says that where the deceased has given or purported to give property to trustees under a trust whereby the income from that property is to be paid in the discretion of the trustees either to persons named in the trust document, or, in the trustees discretion, to other persons not named therein, the value of the property so transferred may not be deducted under Section 7 (1) (d) of the *Estate Tax Act* since:

(a) neither the trust nor the trustees are "an organization constituted exclusively for charitable purposes" within the meaning of Section 7 (1) (d) of the *Estate Tax Act*;

(b) the alleged gift to the trustees is not in law a gift to them that is absolute and indefeasible since they are a mere conduit pipe or vehicle the function of which is to hold the property subject to the terms of trust and to pay the income therefrom to named or unnamed recipients in their discretion;

(c) to the extent that the gift may, in law, properly be considered to be a gift to the ultimate recipients or beneficiaries thereof, it is not absolute and indefeasible since there is no assurance that any of them will receive any portion of the alleged gift."

The first stage is contained in paragraph (a) of the above excerpt from the Reply. It will be noted from the quotation marks surrounding the phrase "an

organization constituted exclusively for charitable purposes" that it was not denied that the Foundation was an organization but rather that it was not constituted exclusively for charitable purposes. The reason for this statement on the part of the Minister appears to be implicit in paragraph (b) in that the Foundation or its trustees could, in their discretion, pay income to unnamed recipients. The language of the trust instrument in this regard was as follows:

> "(a) not less than 90% of the annual income of the fund shall in the discretion of the Trustees be paid to the Institute of Citizenship or to Macdonald Institute or in part to one and in part to the other as the Trustees may see fit to be used by the recipient to provide fellowships or scholarships in fulfilment of the intention of the Settlor;
>
> (b) if the Trustees feel that either of the above designated recipients are not using the amounts received by them in a manner conforming to the intentions of the Settlor, the Trustees in their discretion may pay income of the fund to one or more educational institutions selected by them to be used by such institutions for the purpose above stated;"

The Minister was content that the Institute of Citizenship and MacDonald Institute were themselves charitable organizations but he had no assurance that the income would necessarily go to them. It might be paid to other recipients unnamed and, hence, possibly unqualified. The Minister made no suggestion that it was intended by the late Mr. Harshman or the trustees of his Foundation that the income of the fund he had provided would be used otherwise than for the particular charitable purpose in which he was interested, but it could happen. If the Minister granted the exemption on the assumption that the income would not be diverted to non-charitable recipients, he could do nothing about it if later this is what occurred. If this was the point the Minister was seeking to make, it might seem that the court really did not answer it in holding for the estate. The court did find:

> "that the evidence established that the alternative "educational institutions" which the trustees of The Harshman Foundation could select for the purpose of paying them the income from the fund of The Harshman Foundation instead of to either or both of the Institute of Citizenship or the Macdonald Institute, were intended by the deceased to be only educational institutions in Canada;"

The Minister's argument did not turn on evidence, however, but on the effect to be given to the language of the trust document.

The second stage of the Minister's argument denying exemption is found in clause (b) in the excerpt from his Reply quoted above. The position taken by him was that the Foundation or the trustees of the Foundation, as the Minister preferred to put it, were not ultimate recipients of Mr. Harshman's gifts. For the estate it was argued, as appears from excerpts from its Notice of Appeal, that the

Foundation was an entity or, to use the statutory language, an organization, that as such received monies the income from which was to be distributed by the trustees in their discretion, subject to the prescriptions of the trust instrument, but not pursuant to any directions given by Mr. Harshman.

The Minister, however, likened the trustees to a conduit pipe through whose hands money flowed from the estate to the beneficiaries named by Mr. Harshman except, to revert to stage 1 of the Minister's argument, that Mr. Harshman had not been sufficiently specific as to who these beneficiaries should be. A contrary analogy descriptive of the Appellants' submission, and whether or not it was deployed in argument is not stated, is that the Foundation was a vessel into which the estate funds flowed by one pipe operated by the executors of the estate and out of which income generated in the vessel flowed by another pipe operated by the trustees of the Foundation. This analogy serves rather usefully to point out what seems to be a fatal flaw in the Minister's argument. The Foundation received from Mr. Harshman during his lifetime and under his will gifts that constituted the capital funds of the Foundation. An excerpt quoted from the Appellants' Notice of Appeal refers to a gift of income and capital under the will. It appears elsewhere in the reasons for judgment that this income was excess income after providing a stipulated annuity for the widow. But whether income or capital of the estate, payments to the fund must have been received by it as capital funds.

The trust instrument makes no reference to distribution of capital by the trustees except as to a portion of "realized capital appreciation". It is difficult, in fact, impossible, to think of the trustees as a conduit pipe when they were to keep what they received. What the beneficiaries of the Foundation were to receive from it had its source in the funds of the Foundation.

The court, although not in explicit language, held against the Minister on the point that gifts to the Foundation had not been absolute and indefeasible. In so doing, the court concurred with what appears to have been the major submission on the part of the Appellants, namely that the Foundation was an organization and, moreover, an organization that satisfied the other prerequisites to exemption from tax in respect of gifts made to it. As it is put in the judgment:

> "Section 7 (1) (d) of the *Estate Tax Act*, as amended in 1960, substantially enlarged the number of organizations in Canada to which inter vivos or testamentary gifts could be made which would qualify for deductions for the purpose of computing the aggregate taxable value of property passing on the death of a deceased donor for the purposes of estate tax by the addition of the words "or to the making of gifts to other such organizations in Canada all or substantially all of the resources of which were so devoted". This This subsection does not prescribe how such an organization in Canada must be created. In my view, it may be created in many possible ways, one of which, as found, was the way it was done in this case."

The Minister supported his case by reference to three land mark cases in the field of charitable exemption from income tax*. The court in Harshman's case distinguished these cases in that the relevant statutory provisions being considered in each instance was an exemption granted to a "charitable institution". An aspect of the cases, no doubt regarded as favourable by the Minister, was that a charitable institution was held not to extend to trustees under a will. Another pertinent distinction between those cases and Harshman's case is that in each instance the exemption was sought on behalf of the trustees of an estate from income tax on income from funds of the estate entrusted to them for charitable purposes. Not surprisingly, trustees so constituted were not regarded as a charitable institution and the courts in each of these cases were properly concerned as to the identity and characteristics of each of the ultimate beneficiaries from the trustees. If an ultimate beneficiary was itself a charitable institution, as was the case with certain of the beneficiaries of the Burns Memorial Trust, the income passing to them was declared exempt. When the identity of the ultimate beneficiary could not be ascertained, or if ascertained it was not charitable, the income was not exempt.

The implication of the Harshman decision may be that the courts will recognize a trust standing separate and apart from the trustees under a will as an ultimate beneficiary if, of course, the trust has the aspects of an organization. The reasons for judgment do not attempt to identify the aspects of an organization or weigh their importance otherwise than to note that incorporation is not necessarily one of them.

The fact that the judgment was allowed to stand unappealed despite what could have been regarded as technical deficiencies in compliance with the statute on the part of the Foundation, may also indicate a recognition on the part of the Tax Department that the 1960 amendment to paragraph (i) effected, possibly inadvertently from the Department's point of view, a more radical extension of the scope of the exemption than had been intended. Under the pre-1970 law a charitable organization operated exclusively as such could not have included an organization which existed only to hold and distribute funds among operating charities so to speak, hospitals, schools, churches and so on. Such a distributing organization was recognized under amended paragraph (i) and became entitled to exemption if the other conditions were met. Its function being to distribute rather than operate its own charitable good works, it was no longer fitting to call

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*The Executors of the Will of The Honourable Patrick Burns, deceased, and The Royal Trust Company v. The Minister of National Revenue[1]; The Minister of National Revenue v. Trusts and Guarantee Company, Limited (Peter Birtwistle Trust)[2]; and Trustees of the Estate of James Cosman v. The Minister of National Revenue[3]

1. (1947) S.C.R. 132, (1946) C.T.C. 253, (1946) 2 D.T.C. 893 (1946) Ex. C.R. 229, (1946) C.T.C. 13, (1946) 2 D.T.C. 776
2. (1940) A.C. 138, (1938-39) C.T.C. 371 (P.C.), 1939 S.C.R. 125, (1938-39) C.T.C. 363, (1938) 1 D.T.C. 499-6 (1938) Ex. C.R. 95, (1938-39) C.T.C. 356, (1938) 1 D.T.C. 419
3. (1941) Ex. C.R. 33, (1940-41) C.T.C. 330, (1941) 2 D.T.C. 501

it a charitable organization. The common appellation came to be Foundation, and this is the word Mr. Harshman used.

To the Tax Department, however, the amendment appeared to mean that the donees of exempt donees would no longer be subject to scrutiny to determine whether in fact they were charitable persons. If there was such thinking, the Harshman appeal was a test case of its validity.

Because of the repeal of the *Estate Tax Act* it is somewhat pointless to commence a close study of the language of paragraph (i) for the purpose of assisting in the creation of new Foundations. Before leaving the topic, however, a moment's speculation may be permitted as to the significance of the word "devoted". Should it have the meaning of "prescribed in the founding document" and if so, what words should be used or, more accurately, should have been used to ensure freedom from attack by the Tax Department in the case of a distributing operation? Does the phrase "other such organizations" refer back to the type of organization last mentioned, namely one that does its own charitable work, or to the type of organization that the organization seeking exemption itself is, namely one that distributes? Alternatively, does "devoted" import a factual review of what the organization actually has done with the income from the funds entrusted to it? If this were the meaning, the position might be that the exemption would not attach until the organization was wound up (if ever) because only then could the objects of its devotions properly be known. These questions by no means exhaust the possibilities of trouble under paragraph (i) and it must surely be a cause for relief that draftsmen no longer need be concerned with its uncertainties and anomalies and that in Harshman the courts have given a lead to interpreting it and applying it in a way that will best give effect to the intentions of charitably minded old gentlemen with ample estates.