Viewpoint*

Some Issues Relating to the Treatment of Private Foundations Under the *Income Tax Act*

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1. The Importance of Ending the Existing Discrimination Against Private Foundations

It is vitally important to eliminate the discrimination against private foundations which now permeates the *Income Tax Act*. It must always be remembered that a principal source of capital endowment funds for general distribution to charities has always been private foundations. These have generally been established by individuals who give generously to charities during their lifetimes and who are determined to ensure that this practice be continued by their children, grandchildren and subsequent generations. They may not be prepared simply to donate these capital funds directly to charitable organizations because they are concerned that the activities of such organizations may change over the years and they wish to allow those who operate their foundations after they are gone to have a certain amount of flexibility in allocating charitable donations over the long term. While this practice, like virtually every other activity, is affected by the tax system, it long antedates income taxes.

Private foundations can also afford to be innovative, investigating new problems and finding solutions for them, in a manner which is frequently impractical for charitable organizations and public foundations.

2. The Two Forms of Discrimination

The discrimination in the *Income Tax Act* against private foundations takes two principal forms:

(a) *Gifts of Appreciated Marketable Securities*

While gifts by individuals and corporations of appreciated marketable securities to charitable organizations or to public foundations qualify for inclusion of only one quarter of the resulting capital gain in the donor's income, since the October 18, 2000 Budget, if such gifts are made to private foundations, they enjoy no such benefit. If, for example, marketable securities which cost

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$1,000,000 are donated by an individual to a charitable organization or public foundation at a time when they are worth $4,000,000, only $1,000,000 of the resulting capital gain will be included in income. As a result, for an individual in a 50-per-cent tax bracket, the charitable donations tax credit of $2,000,000 will be offset by a tax of $500,000 in respect of the taxable capital gain, for a net tax advantage of $1,500,000. On the other hand, if the same securities were given to a private foundation, there would be a $2,000,000 income inclusion for the donor. He or she would find that the tax credit of $2,000,000 would be offset by a tax of $1,000,000 on the taxable capital gain, for a net tax advantage of only $1,000,000, amounting to only one-quarter of the value of this gift. This is unfair and unreasonable.

(b) *Gifts of Shares or Debt of Shares or Debt of Private Companies*

Gifts of shares or debt of an entrepreneur's own private company are treated much worse under the *Act*. Typically, the shares of such a company have a very low, or even nominal, adjusted cost base in the donor's hands, with the result that when they are deemed by the *Act* to have been disposed of at their fair market value, the resulting capital gain will be equal to their fair market value. If shares of such a company with an adjusted cost base of nil are gifted to a public foundation or to a charitable organization at a time when they are worth $3,000,000, the resulting taxable capital gain will be $2,000,000, so that a donor in a 50-per-cent tax bracket is subject to a 50-per-cent tax, amounting to $1,000,000, which offsets the charitable donations tax credit of $1,500,000, resulting in a net tax advantage of $500,000, amounting to only one-sixth of the value of the gift.

The situation is even worse when these shares are given to the donor's private foundation. In that case, both the tax credit and the tax on the capital gain are postponed from the time the gift is made until the time when the gift is converted into cash or marketable securities, provided that this takes place within 60 months after the gift. As a result, some donors in these circumstances, seeing that the possible net tax advantage of such conversion is only one-sixth of the value of the gift, will consider forgoing this minor tax advantage, in order to ensure that the donated shares can remain in the hands of their foundations indefinitely.

Many business people whose companies benefit from the small business deduction (the lower rate on the first $200,000 per year of income), are in the habit of arranging for their companies to pay them annual bonuses which are sufficient to keep the corporate income at, or below, the $200,000 level. Since their companies still need capital for further growth, they lend the net bonuses back to their companies after payment of their personal taxes. As a result, their shareholder's loan accounts increase each year, frequently until they become quite large. Until the 1997 Budget, it was quite feasible for such a businessperson to convert a substantial part of this shareholder's loan account into a long-term promissory note of the company, bearing interest at a commercial

rate, and to assign the note to a foundation or a charitable organization, thereby entitling the donor to a charitable donations tax credit for the value of the gift. Now, whether this gift is made to a charitable organization or to a public or private foundation, the tax credit is postponed and will be available only if the note is converted into cash or marketable securities within 60 months of the gift. This anomaly arises because it cannot qualify as an "excluded gift" under the *Act*, even if it is given to a public foundation or charitable organization.

3. Gifts by Foundations to Foreign Charities

The *Act* requires that a foundation be constituted and maintained exclusively for charitable purposes. Revenue Canada acknowledged in writing in 1986 that if the foundation met its annual disbursement quota, either by making the required total amount of gifts to qualified donees such as registered Canadian charities, or by expending its funds directly on charitable activities which the foundation carried on itself, it was entitled to use additional amounts to make donations to *bona fide* foreign charities which were not qualified donees. In 1998, however, Revenue Canada stated that such gifts to foreign charities were prohibited under the *Act* and this prohibition was recently publicized in CCRA's *Charities Newsletter* No. 9. Litigation was commenced by a small private foundation in the Ontario Superior Court of Justice for a declaration that such gifts were entirely legal. The case never came to court when a settlement was reached in August, 2000 to the effect that the foundation could continue to make such gifts, limited to 10 per cent of its total donations. However, the lawyer for Justice in that case indicated that Finance officials would be seeking an amendment to the *Act* in order to prohibit such gifts by a foundation, even if it met its annual disbursement quota.

This would be a most retrograde step. A number of foundations in Canada expend part of their funds on charitable activities in foreign countries as well as in Canada. In order to meet the requirement of the *Act* for meeting the disbursement quota, these foreign activities are generally handled through agency agreements with foreign charities, whereby the foreign charity carries them on as agent for the Canadian foundation. Where larger amounts are involved, this justifies the time and effort involved in negotiating these agreements and monitoring them to ensure their proper operation. However, where the amounts involved are only a few thousand dollars, this time and effort are unjustified and it is normal for outright gifts to be made to the foreign charities. If the *Act* were changed in the manner suggested by Finance officials, it would be necessary for foundations to stop making these gifts unless they were prepared to use and monitor agency agreements.

It is anomalous that the *Act* prohibits outright gifts by charitable organizations to foreign charities since their donations are limited to qualified donees. It is submitted that this justifies alleviating the rule for charitable organizations to

conform with the existing rule for foundations, rather than restricting foundations in the manner suggested by Finance officials.

4. "Ten-Year Capital Gifts" to Foundations

It is common practice for donors of large capital sums to a public or private foundation to stipulate that the gift be subject to a trust or direction to the effect that the property given, or property substituted for it, is to be held by the foundation for a period of not less than 10 years, and sometimes even in perpetuity. This avoids having a value of the gift included in the foundation's annual disbursement quota in the year following the gift. In recent years, however, a number of foundations have discovered that the current rates of interest and dividends which can be obtained from such gifts are insufficient to enable them to meet the part of their annual disbursement quota which is 4.5 per cent of the value of their investment portfolios. While the total yield on their investments might exceed 4.5 per cent if their capital gains were included, they cannot use any part of these capital gains to meet their disbursement quotas, because of the statutory requirement that property substituted for the original gift be held for the period of at least 10 years as stipulated by the donor. This problem can only be rectified by amending the applicable provision, perhaps by replacing it by one that simply requires that during the stipulated period no more than 4.5 per cent of the value of the gifted property or substituted property be expended in any year by the foundation.