New Developments and Challenges With Canada Customs and Revenue Agency*

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Introduction

The law relating to charities and charitable donations is constantly evolving. As a result, practitioners and representatives of charities who deal with Canada Customs and Revenue Agency (CCRA) are regularly encountering new issues and new challenges. This article will review a number of those issues, but time and space do not permit an exhaustive review of the entire field.

Gifts of Encumbered Real Estate

CCRA has recently indicated that it may not necessarily recognize as a "gift", a transfer of real property that is subject to an encumbrance such as a mortgage.

The conventional definition of "gift" requires that there be no consideration received by the donor when property is transferred by way of gift. CCRA has indicated that it may regard the assumption of liabilities by a charity, as a transferee of real property under an existing mortgage, as a form of consideration or other benefit payable to the transferor. In the past, charities, donors and advisors have generally taken the position that when real property is transferred subject to a mortgage, there is a gift for charity law purposes and in particular for purposes of the *Income Tax Act*,[1] with the issue becoming one of valuation rather than one of determining whether there is a gift at all.

There is jurisprudence to the effect that a sale of property in return for consideration that is less than fair market value does not constitute a "gift" of the difference between that fair market value and the amount paid in exchange.[2] Where a property is transferred without any actual payment by the recipient charity but the recipient charity agrees to assume the existing obligations, while technically it can be said that there may be a form of "benefit" received by the donor through the assumption of liability, it should also be noted that, in most provinces in Canada, the donor remains responsible to the original lender under the covenant on the mortgage. For instance, if an individual owns a parcel of real property with a value of $150,000 which is subject to a mortgage of

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$75,000, the equity and therefore the assumed "value" of the property would be $75,000, net of the mortgage. If a charity received that property and issued a receipt to the individual for $75,000, conventional wisdom held that both the donor and the charity were acting appropriately. With the current attitude of CCRA, it appears that economically the donor has transferred $75,000 of equity but has not made any gift at all. Conversely, the charity presumably has received $75,000 of income for which it is accountable, unless it is able to meet its disbursement obligations based on amounts for which it has issued receipts, or unless the property is transferred subject to a 10-year direction.[3]

In Ontario, when property is acquired subject to a mortgage, even if no consideration is paid as such, the Ministry of Finance takes the position that the land transfer tax is payable on the amount of the mortgage assumed, unless there is an exemption for transfers between spouses, or some other exemption. Therefore, at least for land transfer tax purposes, a charity that acquires real property subject to a mortgage will be regarded as having "purchased" that property for an amount equal to the face amount of the mortgage being assumed, and land transfer tax will be payable. I have seen situations in which planning steps were taken in advance to try to lift a mortgage, or in one case, a special dispensation was obtained from the Ontario authorities by way of a remission order to avoid the payment of transfer tax on intermediate steps before the real property was put into the hands of the donor, so that it could be "donated" to the charity.

While it may be possible to restructure these arrangements so that the donor makes a cash payment to the charity in an amount equal to the equity in the property and the charity then purchases the property for that amount, this fundamentally changes the transaction and raises other issues. Interestingly, the administrative position adopted by CCRA with respect to fundraising events, such as gala dinners, permits charities to "bifurcate" a single payment into a gift portion and a nonprofit portion, notwithstanding that case law seems to suggest there cannot be any gift for purposes of the *Act* if any significant consideration is received by the donor in exchange for the payment.[4]

This treatment of gifts of encumbered property is an issue in which it is hoped that CCRA will take a relatively benign attitude although the agency obviously has concerns about the financial viability of a charity that undertakes obligations of this type. It appears that if the property is to be held in perpetuity or for a relatively long period of time, pursuant to a direction from the donor, the charity would incur relatively little risk. It should be noted that there may be other restrictions on the retention of land, such as the requirements in the *Charities Accounting Act* for Ontario property.[5] There is a variety of non-tax issues to be taken into account if a charity is asked to accept a gift of real property, including environmental issues as well as continuing obligations such as property tax obligations, mortgage obligations, etc. These should always be taken into account in analyzing the benefits of a proposed gift.

Maintaining the Status of a Charity After Large Gifts from a Single Source

Under the *Act*, a charity is categorized as a charitable organization, a private foundation or a public foundation.[6] One of the tests affecting designation is whether more than 50 per cent of the capital has been contributed or otherwise paid to it by one person or members of a group of persons who did not deal with each other at arm's length.[7] Generally, when registration is granted, CCRA relies on information provided by the organization seeking registration, however the status is to be determined at a point in time and is not frozen based on information provided at the time the registration is granted. As a result, notwithstanding the fact that a charitable organization or a public foundation may have received its initial financing from a broad variety of sources, there may be situations in which a single large gift would technically cause it to be treated as a private foundation.

In recent months, there have been several widely publicized instances of very large gifts being made to public foundations, such as local community foundations, by entrepreneurs or members of the families of entrepreneurs who have been highly successful in the high tech sector. As a result, it is conceivable that a charity that has in the past received its financing from a variety of arm's length sources may be put "offside" by a single large gift or by a series of large gifts from a related group of donors, such as an entrepreneur and family members or companies controlled by the entrepreneur.

CCRA is aware of this problem and has taken a relatively practical approach. It has said that, provided these are isolated incidents, it will not require a charity to be reclassified merely because it has received a single large donation that would otherwise put it "offside" with respect to the 50-per-cent test. This requires CCRA to use its discretion and to ignore the specific provisions in the *Act*.

However, it appears that this is not a desirable situation. It would be preferable in the view of many advisors, for the *Act* to be amended, to provide clear authority for a charity to preserve its status as a charitable organization or public foundation in these circumstances, and not rely on the whims of CCRA. While a private foundation is entitled to seek to be treated as a public foundation under subsection 149.1(13), there does not appear to be any express provision under which a charitable organization can maintain its status if it would otherwise become a private foundation as a result of such a gift. Since there is no assurance that CCRA will necessarily apply its administrative benevolence in a uniform way, and since there are concerns that the provisions in the *Act* cannot, in any event, be overridden by administrative fiat, even where the administrative guidelines are helpful to the taxpayer, a legislative change in this area would be welcome.[8]

Disbursement Requirements for Private Foundations

Under the *Act*, in order to preserve its status, a private foundation must, among other things, meet its disbursement quota. Given the tax policy which assumes that private foundations are perhaps more open to manipulation, the requirements are more stringent than those for charitable organizations or public foundations, and include an imputed return on investment assets.[9]

It is clear from a reading of the *Act* and the regulations, that once a private foundation meets its disbursement quota obligations, it is not restricted in the way in which it chooses to disburse its funds, provided they are used for charitable purposes. By definition, a private foundation is a charitable foundation that is not a public foundation. A public foundation is a charitable foundation (as defined) which meets certain tests. These tests include a requirement that the organization be "constituted and operated exclusively for charitable purposes" and that no part of the income be payable to, or otherwise available, for the personal benefit of any proprietor, member, shareholder, trustee or settlor and that it not be a charitable organization. As a result, the test is applied first to see whether the charity is a charitable organization. If it is not, it will presumably be a charitable foundation and then will be classified as either a private foundation or a public foundation. The compliance required of the charity will then depend on its classification and in each case there are disbursement requirements.

A number of years ago, CCRA (Revenue Canada Customs, Excise and Taxation, prior to the recent reorganization of the tax directorate in Ottawa) confirmed in private correspondence that as long as the disbursement quota had been met by a private foundation, there was no prohibition against a payment for charitable purposes to any other charitable organization, whether it was registered under the *Act*, was resident in Canada or was based in a country other than Canada. Accordingly, a number of charities relied on this understanding and proceeded to make payments to charitable organizations outside Canada. This was thought to be entirely consistent with the definition of "charitable foundation", which requires only that the organization be constituted and operated exclusively for "charitable purposes" without regard to whether those charitable purposes are carried out in Canada or elsewhere. In contrast, a charitable organization is required to devote all of its resources to its charitable activities, and there is no restriction on the geographical scope of those activities. However, Revenue Canada does insist that if activities are carried on outside Canada, through a third party, there must be clear arrangements under which the Canadian charitable organization maintains control over the funds.[10]

Since one of the requirements for registration under the *Act* is that an organization be resident in Canada, it is not possible for a foreign charity to be registered under the *Act*. Nevertheless, many charities have been formed with the objective of becoming registered under the *Act* and, after meeting their

disbursement quotas and otherwise complying with the requirements in the *Act*, supporting foreign charities or other "charitable" objectives that are carried on outside Canada.

Recently a number of tax practitioners were surprised to find in communications with CCRA that it had revised its earlier position a number of years ago but had not communicated the new position either publicly or privately. The current position has been that *no* payments can be made to a foreign charity, even if the disbursement quota has been met. CCRA insisted that its new position was correct, notwithstanding that it could not point to any express provision in the *Act* or regulations to support it and notwithstanding the provisions which require a foundation to meet its disbursement quota, but do not go further.

As a result, a senior practitioner in Toronto, on behalf of his family's private foundation, took steps in the Ontario court to challenge this interpretation. In recent settlement negotiations, CCRA abandoned its position, acknowledging that in the absence of an amendment to the *Act* or the promulgation of new regulations, there was no authority to require a foundation to apply its funds for charitable purposes only within Canadian borders or only by way of gifts to other registered charities, [11] as long as the disbursement quota has otherwise been met.

To many observers, this situation is yet another indication of the rather high-handed approach taken by CCRA in administering the *Act* based on its own views rather than on the legislation enacted by Parliament. In the minutes of settlement that resolved the challenge, it was agreed by CCRA that it would take no steps to seek to deregister the private foundation based on alleged past transgressions and there was a clear acknowledgment that the private foundation is entitled to continue to make payments to nonCanadian charitable organizations, as long as it otherwise complies with the *Act*.

Restricted Gifts

Under the *Act*, a donor is entitled to make a gift, subject to a direction or trust, requiring the recipient charity to retain the property or substituted property for a minimum of 10 years. In addition to meeting the objectives of the donor, who may want to create an endowment fund and ensure that the property that is given to the charity is applied for particular purposes, (or in some cases held in perpetuity), this type of direction assists the charity in many cases since it provides more latitude in dealing with the disbursement requirements.

For instance, the definition of "disbursement quota" as it applies to a charitable foundation[12] refers, among other things, to the total of amount of gifts for which the foundation has issued an official receipt in the immediately preceding year, other than gifts of capital received by way of bequest or inheritance and gifts received "subject to a trust or direction to the effect that the property

given, or property substituted therefore, is to be held by the foundation for a period of not less than ten years". There is a similar exclusion for gifts received from another registered charity, although these gifts can be subject to special rules, where the gift is a "specified gift".[13]

Frequently, a charity will ask a donor to restrict the gift by imposing a 10-year holding requirement. In other cases, the donor will impose the requirement unilaterally.

In a recent technical interpretation, CCRA dealt with this issue. The situation involved was a fairly common one confronted by many charitable organizations when they seek to disburse an amount that is attributable to appreciation on property that has been given subject to such a restriction. Since a private foundation must measure its disbursement quota by reference to an imputed minimum income of 4.5 per cent based on certain investment assets owned during the previous two-year period, if the funds were not directly used in the fulfillment of its purposes and not otherwise included in its disbursement quota, there is often a concern that the charity, although rich in assets, is poor in cash and not able to meet its disbursement quota. This requires private foundations to adopt investment strategies that take this into account and, of course, all registered charities should have their obligations under the *Act* in mind when investing.

CCRA has stated that gains that have accrued on property that was received subject to a 10-year direction, or property substituted for it, cannot be distributed, without removing the original gift from the exception to the disbursement quota. If a charitable foundation made such a distribution, CCRA feels that it would "appear" to be contravening the terms of the trust or direction, as well as the provisions in the *Act*.

CCRA stated that charitable foundations typically use such gifts for endowment purposes as vehicles for the accumulation of capital to support their long-term charitable activities. Although it acknowledged that the terms of a trust may theoretically provide for the exclusion of gains from the 10-year holding period, CCRA is of the view that "in most cases" any gain realized from the original property would be subject to the same 10-year holding period under the *Act*. It stated that if the foundation were somehow to "extract and distribute" gains realized from the property, it would be contravening the *Act* by distributing a portion of the property that had been given subject to the 10-year requirement. Although CCRA does not address it, there is a very important but separate issue relating to the wishes of the donor. It may be inappropriate for a charity to distribute a portion of the capital that is subject to a 10-year direction without the consent of the donor, unless the terms of the original gift made it clear that capital appreciation was not to be included in the 10-year requirement.

CCRA went on to state that it is possible for the terms of a trust or direction to permit donated property to be substituted, so that the charity has discretion to change the form of the property that is subject to the direction, without being required to retain the very property that was the subject matter of the gift. However, it stated that this does not permit the charity to treat realized gains as being "severed" from the original property that was donated, for purposes of this test, and it referred to case law that suggests that "substituted property" is the total proceeds of disposition of the property for which it is substituted.

This situation illustrates the type of issue that can arise from the perspective of both the donor and the charity where property is given subject to restrictions that it be held for a period of time under the 10-year test. It also illustrates some of the problems that arise from the perspective of the charity when it attempts to meet its disbursement quota, and in particular where it has developed an investment strategy that would otherwise permit it to distribute all or part of its realized gains, rather than capitalize them annually and distribute only "real" income, determined in the accounting sense. As a result, charities should consider carefully the relationship between their "endowment" gifts and their investment strategies, while taking into account their disbursement quotas and the wishes of their donors. In some cases, if the consent of the donor cannot be obtained, it may be necessary to seek a variation of the terms of the trust or direction, if the charity wishes to disburse part of the original capital or part of the incremental capital that arises through gains accrued or realized on the original gift.

Civil Penalties

Recent amendments to the *Act*, following changes introduced in the February, 1999 Budget, could lead to serious consequences for charities and donors, as well as advisors.

When the proposals were introduced, the Minister of Finance referred specifically to instances involving so-called "art flips", in which fairly elaborate arrangements had been developed to permit works of art, with a value of no more than $1,000 (thus eligible to be treated as "personal-use property") to be acquired by potential "donors" at a "discount" to their assumed "real" fair market value. Typically, a "donor" would acquire such a property for say, $400, and then immediately donate it to a receptive charitable recipient which would be prepared to issue an official receipt for a value of $1,000. The charity would in many cases sell the property back to the proprietor at a discount. This created potential problems with the charity's disbursement quota in some cases since it would not have as much cash as it reflected in its official receipts. Since the out-of-pocket costs to the donor would be $400 but the value of the deduction or credit, depending on whether the donor was a corporation or an individual, would be based on a gift of $1,000, and since there would be no capital gain based on the difference between the assumed fair market value and the actual

cost amount (because of the exemption for personal-use property with a cost or proceeds not exceeding $1,000)[14], the mathematics were such that there was an incentive for a donor to take advantage of this type of arrangement, if it worked.

Several cases were taken through the courts. The Federal Court of Appeal has held that the amount paid by a donor does not necessarily establish its "value" when the property is given to a charity, although it is a factor to be taken into account.[15]

For this reason and as a matter of tax policy for a variety of other reasons undoubtedly associated to a large extent with CCRA's wish to codify these rules, the Department of Finance announced in February, 1999 that there would be serious consequences for charities that issued receipts for values that could not be justified. These rules were recently enacted and are now law. There are also penalties for advisors to charities, in addition to the penalties that had always been available to CCRA to attempt to regulate the donors themselves.

The objective is to try to "chill" this type of tax planning, by exposing not only the donor but persons advising donors and presumably those alleged to be "promoting" these types of arrangements, as well as the charities themselves. Despite substantial lobbying efforts by a number of organizations, the rules have now been enacted, and they are very broadly worded.

CCRA has said that it will tread lightly before issuing assessments to charities or their advisors. In a recent edition of *Canadian Tax Highlights*,[16] a representative of CCRA stated that the Minister has undertaken to apply the penalty "fairly, impartially, and only when warranted, by involving the tax community in developing CCRA's administrative guidelines for its application". He stated that while the overall consultation and guideline development process is being managed by the Audit Directorate of the Compliance Programs Branch, a former Assistant Deputy Minister of the Appeals Branch has been engaged to lead the external consultations.

Following internal consultations and preparatory work, CCRA plans to meet with interested practitioner groups to cover a wide range of issues, including the criteria for applying the penalty, the approval process, the notification process and evidentiary documentation. He stated that new guidelines will appear as an information circular and may include examples of the situations in which the penalty will be applied in addition to those set out in the budget material and in the draft legislation documents. A draft of the circular will be distributed to consulting parties before it is finalized and no penalties will be imposed until consultations are complete and the guidelines are in place. He said that final guidelines are expected by the end of this year and that, as previously stated by the Minister, no penalty will be imposed without the approval of a Headquarters Committee to ensure fair and consistent application. Finally, he stated that the Minister is committed to periodically updating

information to the tax community about the experience of CCRA in applying the penalty.

As discussed below, changes announced in the February, 2000 Budget dealing specifically with "art flips" appear to remove much of the incentive for the broad scope of these penalties, particularly as they might otherwise be applied to charities which inadvertently issue receipts for an overvaluation. Nevertheless, this is another instance in which the public is asked to "trust" CCRA, on the assumption that it will act fairly and responsibly in every given situation. The prospect that these types of assessments for civil penalties will be channeled through a national committee, to provide for a "level playing field", is of little consolation to charities and their advisors.

Discretionary Gifts to Charity by Will

On occasion, testators provide in their wills that some of the details of their intended gifts to charity should be left to their executors. This raises questions as to whether the provisions in the *Act* which deem a charitable gift to have been made in the year of death will apply where such a gift is completed after death, or whether the gift will be regarded as having been made by the executors, in the first year or a subsequent year of the estate.[17] Since there are provisions for the carryback of excess donations from the year of death to the previous year,[18] and since a number of other issues depend on the year in which the gift is made, it is important that taxpayers and their advisors understand some of the implications that follow from the use of this type of discretion.

CCRA has addressed a number of situations in technical interpretation letters and has taken what many advisors consider to be an extreme view.[19] In essence, CCRA has taken the view that if the amount of a charitable gift and the recipient charity are not both identified in the will, and the executors are given discretion to set the amount of the gift or choose the recipient, it is the executors rather than the testator who will be regarded as having made the gift. If the estate plan is based on an assumption that the benefits of the tax credit will be available in the year of death, and CCRA takes an assessing position that treats the gift as having been made by the executors in the year of death or in a subsequent taxation year of the estate, there could be adverse consequences. CCRA has taken the view that the intended recipient should be able, by referring to the will, to determine the amount of money it will be entitled to receive at the time of death (subject only to any reduction for the payment of appropriate debts, etc.).

In one technical interpretation letter, CCRA considered a number of separate alternatives.[20] One involved a will that listed a number of charities which would be entitled to receive donations (with a maximum dollar value placed on the total amount to be donated) and giving the executors discretion as to how much was to be donated (to this maximum amount) and the mix among the charities. CCRA stated that since there was no guarantee that any particular

charity would receive any specific amount, it would not regard the gift as having been made by the testator in the year of death for purposes of subsection 118.1(5). The moral of the story in dealing with this type of situation is to proceed with great caution. In some cases, there may be distinct tax advantages in claiming the charitable tax credit in the estate rather than in the terminal return of the deceased. If that is the desired result, it will be important to ensure that it is the executors and not the deceased who will be regarded as the "donor". This can be particularly useful in cases where strategies are implemented to deal with the potential for double taxation resulting from the use of holding companies and where the "stop-loss" rules and the ability to carry back a capital loss from the first year of the estate to offset capital gains tax in the year of death would be relevant.[21]

Where there are gifts to a spousal trust, so that the capital gain on a note or other disposition of the property will be deferred until the death of the spouse, there may be other factors to be taken into account in determining whether the credit for charitable donations should be claimed in the estate or in the terminal return.

There appears to be little if any jurisprudence directly on point with respect to discretionary gifts, although the Tax Court of Canada did consider a gift of a residual interest in an estate to a charity in circumstances in which the actual transfer did not occur until after the death of a life tenant and no official receipt was issued by the charity at the time a credit was claimed for the year of death.[22]

In that case, the Tax Court judge effectively ignored the clear requirement in the *Act* that an official receipt be filed. In those situations involving gifts of residual interest, where the actual transfer will not be completed until a future year, and the value of the gift currently must be determined on actuarial principles taking into account the life expectancy of the intervening life tenant as well as assumed rates of return to arrive at the "present value" of the residual gift which vests immediately in interest but will not be transferred until a future date, the judge took a refreshing approach. He said Parliament could not have intended that an estate be required to obtain a receipt when the charity had not received actual possession and was only a residuary beneficiary. Thus, he permitted the estate to claim a credit in the year of death, based on the actuarial value of the remainder interest that became vested in possession in the charity after calculating the value of the life interest. While this did not deal expressly with discretionary gifts, it did raise questions of valuation, and the Minister had argued that on general principles there was not a gift where there had not been an actual transfer and there might never be a transfer, depending on the contingencies relating to the assets held in a trust during the lifetime of a life tenant.

The judge made it clear that there must be no power to encroach if a gift of a residual interest is to be treated as an immediate gift in the year of death. If

there is a power to encroach, or if there are other contingencies which would make it difficult to value the residual interest or which would create an element of discretion or uncertainty, the gift will not be considered to have been made until the actual transfer takes place. In that event, there may be a mismatch and the tax consequences may not be those that are desired.[23] The current discussions with respect to the use of charitable remainder trusts is a variation on the issue involving gifts of residual interest by will.

Discretionary gifts in wills can raise a number of problems and charities and advisors who are preparing wills with a view to providing this type of discretion are well-advised to consider very carefully CCRA's position on this matter and try to avoid unforeseen consequences.

Electronic Receipts

As a result of a proliferation of Internet services, a number of new services have been offered with respect to solicitation of, and completion of, gifts to charity via the Internet. From a tax perspective, one of the basic questions is whether a charity or its agent is permitted to issue a receipt to a donor electronically.

CCRA has informally advised that, provided the requirements in the regulations under the *Act* are met, it is permissible for charities to issue "electronic" receipts for "on-line" donations. The primary concern of CCRA is that the issuance of receipts is controlled and the donor is not able to alter the amounts shown on the receipt or tamper with any of the other information shown on the receipt. CCRA apparently has no set rules that must be followed but charities that wish to issue electronic receipts are well advised to communicate directly with the Charities Directorate of CCRA in order to ensure that they are in full compliance.

For instance, one of the requirements in the regulations[24] is that the receipt include the signature of a responsible individual who has been authorized by the charitable organization to acknowledge donations and the regulations provide that receipts must be signed personally. However, all official receipt forms must be distinctively imprinted with the name, address and registration number, serially numbered by a printing press or a numbering machine and kept at the place in Canada at which, pursuant to subsection 230(2) of the *Act*, the registered charity is required to maintain its books and records and the receipts can bear a facsimile signature.[25] It appears that CCRA is mainly concerned that the electronic version of a receipt must have a signature in a digitized form, in the same way that documents and correspondence can now include a "signature" that is encrypted onto the document itself.

In some cases, intermediary organizations arrange for the donations, receiving the funds and passing them on as agent for the charity, and issuing receipts on behalf of the charity, in exchange for a fee. It will be important that the process

of issuing receipts be carefully monitored, particularly where the agent purports to issue the receipt on behalf of the charity and the "supply" of blank receipts may not be strictly in compliance with the requirements in the regulations. This is another example of an area in which the law will presumably evolve to try to stay abreast of the marketplace.

Recent Jurisprudence

There have been several cases in the past year or so which deal with issues relating to charities.

In *Woolner*,[26] the issue was whether taxpayers who had made contributions to their local church were entitled to tax credits in circumstances in which there was an understanding that the church would support an affiliated private school attended by children of the taxpayer and that bursaries would be available to them. The Court considered the definition of "gift" and whether, in the circumstances before it, it could be said that there was no link between the payment to the church and the education and bursaries received by students at the private school. In referring to earlier jurisprudence, the Court confirmed that a gift at common law (which applies for purposes of the *Act*) is a voluntary transfer of property from one person to another gratuitously and not as the result of a contractual obligation, without anticipation or expectation of material benefit. It held that the contributions to the church were voluntary but the main issue was whether the contributions were made with the anticipation of a benefit or advantage of a material nature. The Court followed earlier decisions dealing with education at private schools and found that the *Zandstra* case[27] was determined. It found that the taxpayers made their contributions to the church with the anticipation that their children would be provided with a bursary. The Court stated that while a parent could "theoretically" not pay any money to the church for a child to receive a bursary, all parents would also presumably understand that if each and every parent refused to donate money to the church, there would not be enough money to provide students with bursaries. The Court rejected an argument by the taxpayers that there was no link between the contributions to the church and the bursaries awarded to the children by the school, and found there was clear evidence that such a link did exist.

CCRA has indicated that it will continue to monitor the circumstances in which advantages received by donors may or may not be regarded as sufficient to "taint" a gift. For instance, in its most recent newsletter,[28] CCRA stated that it is concerned about a misconception circulating within the charitable sector with respect to the definition of gift. It referred to paragraph 15(f) of *Interpretation Bulletin* IT-110R3, and the view of many members of the public that a donor cannot give to a charity from which the donor benefits to the same level as other members of the public. CCRA described various examples in situations in which a gift will not be tainted merely because the donor has some affiliation

with the recipient charity, such as a donor who supports a favourite symphony, hospital, library or church with a payment for which he or she does not directly receive something in return. In that event, CCRA said that the donor is "likely" making a gift but it also stated that a receipt cannot be issued to a donor who makes a payment to a charity on the understanding that he or she will receive some "special benefit in direct return for the payment", and it referred by way of example to a donation of a painting to a museum in return for free appraisals for the private art collection of the donor.

In *Zelinski*,[29] the taxpayers had acquired several hundred works of art and donated them to various galleries and museums, treating them as Canadian cultural property and avoiding any accrued capital gains while at the same time claiming credit for the full fair market value of the donations. The Minister argued that the values were overstated and further argued that the taxpayers had engaged in an adventure in the nature of trade and therefore the works of art were not capital property.

The Court held that there cannot be an adventure in the nature of trade when property is acquired for the purpose of making a donation, since by definition it cannot produce any "profit" if there are no sale proceeds. It also rejected an argument by the taxpayers that the cost of property is not relevant to the fair market value at the time of a later gift.

In *Aikman*,[30] a group of taxpayers purchased a prototype helicopter at an amount less than its fair market value and donated it as Canadian cultural property. One of the main issues related to valuation. The judge confirmed that the cost of the property was to some extent contingent and therefore, if the cost were relevant in determining the fair market value, the fact that payment was contingent on an appropriate tax result would be relevant. However, the judge also stated that as a matter of procedure, notwithstanding disagreement among the experts called by the Minister, this was not sufficient to shift the onus to the Minister. The taxpayers argued that since the Minster had not met the onus, the valuations presented by the taxpayers, which were not rebutted, must be accepted by the Court. Since there was clearly no "market" for the property, which was unique, the judge reviewed extensively the definition of "fair market value" and expressly rejected the argument by the Minister that the amount paid to acquire the property was the best indication of its value when it was donated. The judge also rejected an argument by the taxpayers that the vendor was not knowledgeable and therefore the amount paid to acquire the property was less than its fair market value. He stated that even if he rejected the adjusted cost base relied on by one of the experts for the Minister, there was no sound footing on which to arrive at a different figure for cost. Nevertheless, he expressly stated that replacement cost was not necessarily a good indication of fair market value and the amount paid by the taxpayers was not indicative of value because it was contingent and refundable and was based on the tax results of the donation.

The judge also stated that a taxpayer's motive in acquiring an object of cultural property with the intention of donating it to a specified institution is irrelevant and that if a taxpayer is able to obtain such an object for a price that is less than its fair market value with the intention of obtaining a tax advantage by making a charitable gift, this is perfectly acceptable. He added that an appellant in such circumstances runs a risk that the Board or the Court may conclude that the best evidence of fair market value is the price at which the object was purchased.

As a result, it seems clear that CCRA's continued reliance on the cost of a property that is donated within two years of purchase is misplaced and the cost is only one of the many factors to be taken into account in establishing the fair market value of property when it is donated.

In *Douziech*,[31] the taxpayer claimed the benefit of a longstanding administrative practice of CCRA with respect to "splitting" charitable donations between spouses. Since the taxpayer was not legally married to his "spouse", the Minister did not permit him to claim credit for donations made by her. The judge referred at length to CCRA's well-known and well-publicized administrative practice in this area, but ultimately concluded that since there was no ambiguity in the law he was bound to apply the law as Parliament wrote it and there was no way in which the taxpayer was entitled to claim the credit. The judge said that there was "considerable unfairness" in refusing to grant the taxpayer the benefit of the deductions merely because he was not legally married. He stated that the Minister might be prepared to give relief by way of a remission order under the *Financial Administration Act*. This is yet another instance of what is generally regarded as a permissive administrative approach on the part of CCRA being applied despite the letter of the law. The result illustrates the fact that the very administrative practice itself is without legal foundation.

Statutory Changes

As noted above, the February, 1999 Budget introduced a number of changes dealing with charities and those changes have now been enacted. Further changes were introduced in the February, 2000 Budget. These include changes in the capital gains inclusion rate from three-quarters to two-thirds, changes with respect to the donation of shares acquired through the exercise of stock options, preferential treatment for transfers of ecologically sensitive property, relieving provisions permitting direct designations of life insurance proceeds and payments from registered plans such as RRSPs and RRIFs (but not RRPs) to the charities and restrictions on the use of the personal-use property rules and the $1,000 threshold, if property is acquired "as part of an arrangement under which the property is gifted" to a qualified donee.

The general approach to capital gains was to reduce the inclusion rate from three-quarters to two-thirds. This has a "spin-off" effect on the consequences

of donating marketable securities to eligible charities and there will be corresponding changes to ensure that shares acquired pursuant to stock options will receive equally favourably treatment, and to avoid what had been an unintended result.

The ability of donors to designate payments under life insurance policies and deferred plans so that charities can receive those payments directly is welcome. This will avoid having to flow funds into an estate, subjecting them to probate tax, and having them then paid out pursuant to a provision in a will. In some cases, depending on the financial viability of an estate, there may be potential liability concerns where funds are designated directly from an RRSP or RRIF. Under section 160.2, where an amount is received out of such a plan by a person who is not an annuitant, that person may be liable for unpaid taxes. This should be taken into account when making direct designations in RRSPs or RRIFs, quite apart from probate tax and other issues.

The changes dealing with personal-use property are designed to address the perceived concerns discussed above with respect to "art flips". The objective is to prevent taxpayers from avoiding capital gains on donations of property that have a fair market value not exceeding $1,000, if there is an "abusive" scheme involved. It remains to be seen how the courts will interpret the word "arrangement" where property is gifted to take advantage of the personal-use property rules.

In the recent mini-Budget on October 18, 2000, the Minister of Finance proposed to lower the capital gains inclusion rate from two-thirds to one-half. Corresponding changes will follow for gifts of marketable securities, stock option shares and ecologically-sensitive land, to ensure that the appropriate reductions in capital gains are available.

The rules dealing with gifts of marketable securities and ecologically-sensitive property are subject to "sunset" provisions. I understand from recent surveys taken by various groups knowledgeable in the charitable sector that the response to these new incentives has been overwhelming. It is hoped that the Department of Finance will see fit to extend these rules indefinitely, since they appear to be achieving the desired result.

Miscellaneous

Very recently there have been reports in the news about the direct issuing of stock options to charities by startup companies, generally in the high tech sector. Special rules have been put into place on the Toronto Stock Exchange to accommodate this from the perspective of securities law. Although the issuing corporation that grants the options and ultimately will issue the shares if the options are not exercised, will not be entitled to a deduction for a donation (notwithstanding the fact that the shares may later prove to be very valuable), this is a very innovative technique and illustrates philanthropy at its best. It is

unusual in this day and age of sophisticated tax planning to see situations in which business organizations are prepared to provide a potential for large future benefits to worthy groups, without looking for an immediate tax benefit.

There have also been recent reports in the news about restructuring the McMichael Canadian Collection. [See Shamin Lalani, "Dancing the Intricate Tango", Volume 16, No. 2, *The Philanthropist*, at p. 104.] It appears that the very large collection, which has grown well beyond the donor's original concept, may be reduced through a form of "decommissioning". To the extent that works of art have been acquired subject to directions from donors or in trust, there may be both tax and nontax issues.

In addition, if the works of art were received as objects that qualified as Canadian cultural property, the potential for a penalty under section 207.3 may be relevant. This penalty is designed to require public institutions that receive gifts of cultural property to retain them for at least 10 years unless they are transferred to another eligible institution. Presumably this and the other implications of reducing the Collection or otherwise bringing it into line with the views of the original donors will be taken into account in any reorganization of the Collection.

Conclusion

There have been a number of developments recently that will have a direct bearing on the charitable sector. The foregoing is a brief outline of some of those developments. Charities and their advisors, as well as donors, should monitor future developments, to try to stay abreast as the environment for charities and charitable giving changes.

FOOTNOTES

1. R.S.C. 1985, c.1 (5th Supp. as amended, hereinafter referred to as the *Act*). Unless otherwise stated, all statutory references in this paper are to the *Act*.
2. See, for example, *Hudson Bay Mining and Smelting Co. Limited* v. *The Queen*, 89 DTC 5515 (FCA), confirming 86 DTC 6244 (FCTD), in which an overpayment made by a purchaser to parties related to the vendor, and a payment through which it was recovered by a "donation" by the vendor to the purchaser, were treated as a single transaction, no part of which constituted a gift. See also *The Queen* v. *Littler*, 78 DTC 6179 (FCA), in which it was stated that the word "gift" in a taxing statute must be taken as referring to what is known to the law as a gift, namely, the gratuitous transfer of property, and the difference between value and price is not "property" and is not something that can be transferred.
3. Generally, charitable organizations and public foundations have fewer disbursement obligations than private foundations. In addition, private foundations are prohibited by subsection 149.1(4) from incurring indebtedness except in specific circumstances. It seems that a foundation acquiring property that is already subject to an encumbrance may not be "incurring" any debt obligation, if there is otherwise a concern.
4. See, for instance, *Interpretation Bulletin IT-110R3, Gifts and Official Donation Receipts*, at paragraphs 4 through 8.

5. R.S.O., 1990, c. C.10.
6. See subsection 149.1(6.3), which permits the Minister to designate a registered charity as a charitable organization, private foundation or public foundation and subsection 149.1(13), which permits the Minister to designate a private foundation as a public foundation. Typically, the Minister designates a charity when registration is granted and changes will thereafter be made if circumstances change and either the charity seeks a change or the Minister makes a new designation.
7. See the definition of a "charitable organization" in subsection 149.1(1).
8. There is ample case law to support the proposition that CCRA does not have jurisdiction to ignore the provisions in the *Act* although, as a practical matter, there are many situations in which this occurs. For instance, the treatment of payments for fundraising dinners and the whole scheme of charitable gift annuities are technically not in compliance with the *Act*.
9. See the definition of "disbursement quota" in subsection 149.1(1).
10. CCRA has recently issued a revised draft of its policy statement dealing with foreign activities of Canadian charities. For a more detailed discussion of this topic, see David G. Amy, "Foreign activities by Canadian Charities", Vol. 15, No. 3, *The Philanthropist*, at p.41. [Readers are also directed to the *Viewpoint* by Wolfe D. Goodman, Vol. 16. No. 2, *The Philanthropist*, at p. 100.]
11. It should be noted that not all "qualified donees" are necessarily "charitable". As a result, certain payments by a registered charity to a qualified donee may be permissible from the perspective of disbursement quota requirements but may not constitute charitable activity, as a matter of provincial law regulating charities. Subsection 149.1(6) deems certain payments to a qualified donee to be a devotion of resources to charitable activities by a charitable organization. The definition of "charitable purposes" in subsection 149.1(1) includes the disbursement of funds to qualified donees.
12. Subsection 149.1(1).
13. Subsection 149.1(1) provides that a specified gift is a gift made by a registered charity that is designated as such in its information return for the year. There are special rules dealing with specified gifts from the perspective of both the recipient and the donor.
14. When the capital gains tax was introduced in 1972, a "safe haven" rule was added which permits dispositions of "small" personal-use assets to be disregarded, if transactions involve less than $1,000 in the form of cost or sale proceeds. See section 46.
15. See the discussion below dealing with recent jurisprudence and statutory charges.
16. Vol. 7, No. 7, July 25, 2000.
17. Under subsection 118.1(5) of the *Act*, generally where an individual makes a gift by will, that gift is deemed to have been made by the individual immediately before death. In this way, the tax consequences of the gift are the same as if the individual had completed the gift while alive and immediately before death.
18. See subsection 118.1(4).
19. For a discussion of various implications of bequests and estate planning in general, and this issue in particular, see D. Bruce Ball and Brenda R. Dietrich, "Bequests and Estate Planning", Personal Tax Planning feature (1999), Vol. 47, No. 4, *Canadian Tax Journal*, 995-1018.

20. Document No, 9732295, March 20, 1998.

21. See subsection 164(6).

22. *O'Brien Estate* v. *MNR*, 91 DTC 1349 (TCC).

23. CCRA has dealt with certain types of "delayed" gifts involving residual interest in real property and equitable interest in trusts. See *Interpretation Bulletin IT-226R, Gift to a Charity of a Residual Interest in Real Property or an Equitable Interest in a Trust*, November 29, 1991.

24. Regulation 3501(1)(i).

25. Regulation 3501(3).

26. *Woolner* v. *Attorney General and the Ontario Alliance of Christian Schools Societies* (Intervenor), 99 DTC 5722 (FCA).

27. *The Queen* v. *Zandstra*, 74 DTC 6416 (FCTD).

28. *Canada Customs and Revenue Agency Newsletter 9*, Spring 2000.

29. *The Queen* v. *Zelinski, Whent and Pustina*, 2000 DTC 6001 (FCA).

30. *Aikman* v. *The Queen*, 2000 DTC 1874 (TCC).

31. *Douziech* v. *The Queen*, 2000 DTC 3613 (TCC).