Position Summary

CANADIAN BAR ASSOCIATION CHARITY & NOT-FOR-PROFIT LAW SECTION

[The following is the text of the Section's National Tax Committee's position summary for a November 27, 2002 meeting with the Department of Finance and Canada Customs and Revenue Agency Charities Directorate.]

The following represents (in no particular order) areas for discussion with the Canada Customs and Revenue Agency Charities Directorate and the Department of Finance. If there is interest in pursuing any of the suggestions, we would be pleased to develop more detailed submissions upon request.

Given the Voluntary Sector Initiative currently underway, we assume that issues which require meaningful policy level consideration may not be open for discussion other than in the context of the Regulatory Joint Table. Thus, while we will express our views with respect to a range of topics, we recognize that some may not be open to consideration at this time. However, if you are prepared to discuss policy issues as well as more technical issues, we would be pleased to participate.

Proposed Legislation

We would like to discuss whether any proposed legislation is currently contemplated which will affect charities or their donors, including in particular whether any consideration is being given to defining "gift" or "charity" in the *Income Tax Act*.

4.5 Per Cent Disbursement Quota

The 4.5 per cent disbursement quota was introduced in the early 1980s when interest rates of more than twice the 4.5 per cent disbursement quota were available on secure investments. Now that interest rates on secure investments are less than the 4.5 per cent disbursement quota, the 4.5 per cent is often not attainable without encroaching on capital. However, many charities are not able, as a matter of trust law, to encroach on the capital of their endowments. This is particularly true of charities which have received gifts subject to trust conditions or directions requiring that the property be held for at least 10 years. While we realize that a registered charity may apply for a reduction in its disbursement quote pursuant to subsection 149.1(5), this process is inefficient (particularly as it needs to be used each year by more and more charities as they use up the disbursement excess accumulated in past years).

We recognize that various proposals have been suggested to solve the problem. One simple solution would be to replace “0.045" in the definition of disbursement quota with ”prescribed amount". The prescribed amount should be set annually in advance as a portion (perhaps one half) of the yield on Government of Canada bonds. The prescribed amount should be set low enough that a registered charity which obtained an investment yield on Government of Canada bonds would still have investment income available to pay its administrative expenses, assuming these expenses do not count toward the disbursement quota.

Since many charities have disbursement problems of the nature described above for current years, it would be helpful if any changes could take effect for past years.

Capital Gains and 10-Year Gifts

In addition to problems with the 4.5 per cent disbursement requirement in general, the Canada Customs and Revenue Agency takes the position that it is not possible to use realized capital gains to supplement other income from property subject to a 10-year gift in order to meet the 4.5 per cent disbursement quota. This creates problems for many charities.

One possible solution would be to amend the definition of 10-year gift by stipulating that during the 10-year period the foundation may disburse annually up to the greater of 4.5 per cent (or the prescribed amount – as proposed above) and the actual income from the 10-year gift during the year. This would allow the foundation to use capital gains (or even original capital) to meet its disbursement quota if necessary. Of course, donors would still be free to impose more stringent conditions if they wished and conditions on past gifts would continue to apply as a matter of provincial law.

Transfers of Property Subject to 10-Year Conditions

Until recently, it was assumed that a registered charity which transferred property subject to 10-year conditions could transfer the property as a specified gift which does not have disbursement quota consequences for the transferor or the transferee charity.

However, this issue was referred recently to the Canada Customs and Revenue Agency Rulings Directorate, which took the position that the terms of paragraph A.1 of the definition of disbursement quota in subsection 149.1(1) had an unfortunate result. Because the proposed transfer in that situation included these 10-year gifts which were being expended in the year by being transferred to another foundation, 80 per cent of the amount of the gifts was required to be included in the transferor’s disbursement quota in the year of transfer. However, subsection 149.1(1.1) prohibited such a specified gift from being

deemed to be an amount expended in the year on the transferor's charitable activities. This prevented the transfer because the transferor would not be able to meet its disbursement quota if the transfer took place.

If the analysis of the Rulings Directorate is correct, it implies that a drafting error was made in 1993 when paragraph A.1 of the definition of disbursement quota was added. Subparagraph (a) of this paragraph should read "is expended in the year, otherwise than by way of specified gift". Thus, we request that the Department of Finance make this technical amendment to correct the 1993 drafting error.

Transfers Between Foundations

Gifts made by another charity to a public foundation or a private foundation also result in a similar disbursement quota problem. Under the definition of disbursement quota in subsection 149.1(1), a gift from a registered charity to either a private foundation or a public foundation must be included in the calculation of the disbursement quota for the transferor charity unless the gift is designated as a specified gift. If it is so designated, the gift is excluded from the calculation of the disbursement quota for the transferee foundation, but at the same time is excluded from the calculation of the expenditure required to meet the disbursement quota of the transferor charity.

The difficulty arises where the transferor charity is either a private foundation or a public foundation and is making a gift to another foundation but does not want to exclude the gift from the calculation of its expenditure in meeting its own disbursement quota. As a result, the transferor charity may not agree to designate the gift as a specified gift. However, if the gift is not designated as specified gift, then the transferee foundation would have to include 80 per cent of the gift in calculating its disbursement quota for the year in which it was received. This would not be acceptable to the transferee foundation where the gift is intended to be held as either an endowment fund or as another form of long-term gift.

We suggest that the rules be amended to prevent this unintended result from occurring.

Grants by Registered Charities to Foreign Charities

The *Income Tax Act* permits a registered charity which is a foundation to make grants to a foreign charity once the registered charity has met its disbursement quota. We understand the Department of Finance intends to introduce an amendment to prevent foundations from making such grants. We do not believe that such an amendment serves any policy purpose.

Our general view is that there is no policy reason why, in a system which permits Canadian registered charities to conduct foreign charitable activities,

Canadian registered charities may not also make grants to foreign charities. Thus, we prefer to see the *Income Tax Act* amended to permit all Canadian registered charities to make grants to foreign charities. While we recognize the need for the Canada Customs and Revenue Agency to be able to ensure compliance with the requirement that all resources of a registered charity be devoted to a charitable purpose (particularly after September 11), we believe that this could be achieved through allowing foreign charities to become registered charities (for the limited purpose of grant eligibility and with no ability to issue receipts to individual or corporate donors). This is the current situation in the U.S.

Even if it is not possible to change the *Income Tax Act* to permit charitable organizations to make grants to foreign charities, there is no reason to change the law to prevent a charitable foundation from making foreign charitable grants after meeting its disbursement quota. The Canada Customs and Revenue Agency should confirm that under the current law, a foundation may make such grants. This would be an appropriate topic for a future Registered Charities Newsletter.

Charitable Remainder Trusts

The situation in Canada governing charitable remainder trusts (CRTS) is not satisfactory. The basic treatment of gifts in this form is governed by the general tax law relating to trusts and can be summarized as follows:

(a) CRTs which are spousal trusts or alter ego trusts are entitled to rollover treatment on settlement. In general, the settlement of any other CRT gives rise to deemed proceeds of disposition equal to the fair market value of the property gifted unless the settlor or the personal representative elects lower proceeds under subsection 118.1(6) of the *Income Tax Act*. This election is available only in respect of the remainder, not the life interest.

(b) CRTs which are spousal or alter ego trusts are subject to a deemed disposition on the death of the life tenant. All other CRTs are subject to a deemed disposition on their 21st anniversary date.

(c) Capital gains, both deemed and realized, of a CRT, are subject to the highest marginal rate of taxation, even though a charity is ultimately entitled as the capital beneficiary to the capital gain. This rule applies regardless of whether the CRT was established on a rollover basis and regardless of whether the charity's remainder interest is vested in interest.

(d) A donation credit on the settlement of the trust is available only in the circumstance where there is no power of encroachment in favour of the life tenant. This treatment contrasts unfavourably with the treat-

ment of CRTs under U.S. tax law. U.S. tax law allows for charitable remainder annuity trusts (CRATs), which permit the settlor to reserve a life annuity payable out of income (and, if need be, capital), and charitable remainder unit trusts (CRUTs), which permit the settlor to receive a specified percentage, not less than five per cent of the value of the settled fund.

Elements of the treatment described above make this form of charitable giving relatively unattractive in Canada. We understand that a task force led by the Canadian Association of Gift Planners is completing a detailed submission in support of more advantageous treatment for CRTS. We support this initiative generally. In order to encourage gifts of this type, we suggest that the Department of Finance investigate:

(i) ways of according fairer treatment of capital gains (actual and deemed) by CRTs which are settled on a non-rollover basis;

(ii) ways of according fairer treatment of capital gains (actual and deemed) by CRTs settled on a rollover basis; and

(iii) ways of allowing for the more flexible design of CRTs similar to the U.S. CRATs and CRUTs.

Gifts Made by Will and the Deeming Rule in Subsection 118.1(5)

Subsection 118.1(5) provides that gifts made by an individual in his or her will are deemed to have been made immediately before the individual's death. This provision reflects the position at law that an individual's last will and testament is his or her last juridical act and, as such, speaks from the date of death. It clarifies the treatment of such gifts and, perhaps generously, allows them (in fact, requires them) to be taken into account in the terminal year. This policy of generous treatment of gifts made in the terminal year or by will is reflected as well in the provisions which allow a credit in the terminal year for gifts equal in value to the total income in that year and in the proceeding year.

We suggest that this generous policy be extended by making the treatment of gifts by will accorded in subsection 118.1(5) optional rather than mandatory, so the gift made by will can be treated as made, at the option of the personal representative, in the terminal year or by the estate in the year following death. Alternatively, and perhaps preferably, the same result can be achieved by allowing surplus gifts to be carried forward one year to the estate (much as subsection 164(6) allows losses to be carried back to the terminal year). This treatment would be useful in situations where considerable income is realized by the estate, perhaps through the redemption of holding company shares resulting in a deemed dividend, but not in the terminal year because of the carry back of capital losses.

Gifts to Charity of Property of Spouse After Death of Spouse

It is not uncommon for an individual to establish a spousal trust by will with a gift of the remainder to a charity. In some situations, the remainder interest in favour of the charity can be treated as a gift at the date of death but in others, for example, where there is a power of encroachment in favour of the spouse, the gift is not recognized for tax purposes until the spouse dies. In some of these situations, such as where the trustee has a broad discretion to select the charity, the spouse trust may obtain a donation credit for the gift. In situations where the trust year end follows quickly after the spouse's death, there may be insufficient time to arrange the gift. Yet, if the gift is not made before the trust year end, the donation credit may well be lost since it cannot be carried back and used in the year in which there may be a substantial income tax liability due to the deemed disposition.

We suggest there should be a provision in the *Act* that allows the spouse trust to carry the donation credit back one year so these gifting arrangements do not have to be rushed. Where a donation credit is not allowed on the date of settlement or death because there is a power to encroach in favour of the life tenant, technically there may be no credit at all since at the date of termination of the life estate, there is no gift by the trust. Rather, on the termination of the life estate, the remainder interest merely falls into possession. The Canada Customs and Revenue Agency has an administrative practice of allowing a credit to the trust in these circumstances. We think there should be a legislative provision which places this treatment on a more secure footing.

Gifts of Appreciated Public Securities

We appreciate the announcement that the one-half capital gains inclusion rate for gifts of listed public company shares and mutual fund units to charitable organizations and public foundations has been made permanent. However, we think there is no policy reason to limit this incentive to charitable organizations and public foundations.

If there are particular abuses with which the Department of Finance is concerned and which are seen to justify different treatment of private foundations, these abuses should be dealt with directly. Furthermore, given that this donation incentive is limited to public company shares and mutual fund units, the possibilities for transactions between a donor and a private foundation to involve self-dealing are limited.

Registration Appeals

At present, the refusal by the Canada Customs and Revenue Agency to register an applicant as a charity does not result in any public decision record. We think this is a flaw. If the refusal to register resulted in a written public decision (like those delivered by the Charity Commission for England and Wales), helpful

administrative precedent would become available to the charitable sector and professional advisors, resulting in better applications for registration. Thus, we think the *Income Tax Act* should be amended to require written public decisions (subject to confidentiality concerns) where a decision is made to deny charitable registration.

Furthermore, when a registration is refused, the *Income Tax Act* requires an appeal to the Federal Court of Appeal. This is an inappropriate and expensive appeal route. We think the rules should be amended to give the Tax Court of Canada original jurisdiction in appeals from the refusal to register entities as charities.

Inadvertent Private Foundation Status

The *Income Tax Act* defines both charitable organization and public foundation to require that not more than 50 per cent of the capital which has been contributed to the organization or foundation has been contributed by one person or by members of a group of persons who do not deal with each other at arm's length. Charities which fail this 50 per cent of capital contributed test are private foundations.

While the 50 per cent capital contributed restriction appears to have been added to the *Income Tax Act* to catch the typical private family foundation, it can also catch otherwise public charities which receive large gifts from one source.

We understand the Department of Finance recently issued a comfort letter indicating that this result was not appropriate with respect to a charitable organization and that the Department of Finance intended to recommend that the *Income Tax Act* be amended to provide that the 50 per cent of capital test be replaced with a requirement that the large donor be at arm's length with the recipient charity after the donation and not control the charity or any activity of the charity. We understand it has been suggested that the same change should be applicable to the definition of charitable foundation. We agree that the same change should be made to the definitions of both "charitable organization" and "public foundation".

We understand a concern has also been raised about the proposed requirement that the donor not control an activity of the charity. We think this could be interpreted narrowly to apply to entirely appropriate situations (like a community foundation fund). We agree with this concern and suggest that the reference to control over an activity of the donee be removed.

Finally, despite the comfort letter, we understand the Canada Customs and Revenue Agency charities examiners are refusing to apply the comfort letter. Therefore, we request that the proposed amendment be made as soon as possible.

Registration Delay

The delay in registering charitable organizations (if not foundations) seems to be growing rather than shrinking. This seems to be a function of resource constraints and of a new approach to the determination of whether the applicant is eligible for registration.

There appears to be a view among some Canada Customs and Revenue Agency charities examiners that unless a charity can prove that all of its activities will be charitable, it cannot be registered. While it may be simple to show that an applicant has charitable purposes, a new organization with no track record will often have enormous difficulty in showing that its activities (which are all proposed activities and are usually dependent on the uncertain vagaries of its donors) will be charitable. It is our view that once an applicant can show that its purposes are exclusively charitable, concerns about its activities (unless the problem giving rise to the concern is patent) should be dealt with at the audit level. We recognize that the audit scrutiny of charities would need to be expanded in order to make this proposal work.

We are also concerned that charities examiners frequently ask applicants for undertakings to do certain things before granting registration. It is our experience that the undertakings seem to cover areas that the Canada Customs and Revenue Agency wishes it had the power to regulate but which are not covered as a matter of ongoing compliance by the *Income Tax Act*. For example, applicant charities which might at some time carry on activities outside Canada are sometimes required to undertake not to do so without pre-clearing their agency or joint venture agreements with the Charities Directorate.

We think that since these requests for undertakings are not made pursuant to any statutory authority, they may not be enforceable. Even if they are enforceable, they should not be requested in the absence of a specific statutory obligation.

Charity Audit Issues

There are not enough audits of registered charities to meet the stated purposes of educating and ensuring compliance. Auditing 419 of 77,432 registered charities in 2000 (which we understand was the case) is a very low rate and suggests that audits only take place as a result of specific leads and are therefore less likely to have educational value. Furthermore, many of the auditors who are assigned to audit charities are drawn from Consulting and Audit Canada and seem to have very little knowledge of charities or the law applicable to them. Better-trained auditors would result in less frustration for charities and more robust audit findings for the Canada Customs and Revenue Agency and therefore more compliance by charities.

When audits do occur, audit follow-up is frequently delayed so long that the charity may have no staff member left from the period at issue who is still with the charity and able to respond. This dramatically reduces the effectiveness of the audit. We think improving the quality and timing of audits should assist in eliminating the delays in dealing with applications for registration.

Change Approval Delay

The Canada Customs and Revenue Agency Charities Directorate takes the position that a registered charity which makes changes to its objects should pre-clear the changes with the Directorate. We believe that the *Income Tax Act* is clear that once a charity is registered, it remains entitled to be registered until it ceases to meet the qualification for registration (based on the requirement for exclusively charitable purposes). Thus, we think a registered charity may, as a matter of law, change its objects or focus without pre-approval.

Nevertheless, it is very useful to be able to pre-clear corporate changes with the Charities Directorate, particularly in the case of changes which are not clearly within the scope of what is charitable. However, the current backlog of approximately two years limits the utility of the pre-clearance process. Few charities are willing to wait two years to find out if they can change their objects (which they likely view as a housekeeping matter anyway).

Civil Penalties

Other than for valuations which are provided by or relied upon by a charity, we do not believe that section 163.2 penalties should apply to registered charities except in very unusual circumstances. Many charities provide advice to donors about the tax consequences of making charitable gifts – advice which, if inaccurate, could trigger subsection 163.2 penalties. Given the context of complex legal issues and volunteer fundraisers in which most charities operate, we think charities and their in-house fundraisers (not including their outside professional advisors and fundraisers) should not be subject to civil penalties except in the most egregious cases.

We believe that it would be helpful for the Canada Customs and Revenue Agency to comment on the application of civil penalties to charities and their staff. Since Information Circular 01-1 has been released, it might be appropriate to make such comments in a future Registered Charities Newsletter. We would like to have an opportunity to provide input on those comments before they are made.

Donations of the Use of Recreational Property

The current position of the Canada Customs and Revenue Agency (as expressed in *Income Tax Technical News 17*) is that the donation to a registered

charity of the right to use recreational property for a defined time period is not a donation of "property" as required by the definition of gift.

As a technical matter, we believe it is possible for the right to use recreational property for a defined time period to be "property" and thus the subject of a gift. However, we acknowledge that if the right to use the property is part of the property itself and not a separate property, in order to sever this property interest from the fee simple interest of the donor, it might conceptually be necessary for the donor to be deemed to dispose notionally of all of his interest in the subject property. This would not appear to be a practical approach to this issue. We realize that the transaction costs of turning the right to use recreational property for a defined time period into a property interest in the land that can be the subject of a gift might be prohibitive and would often have undesirable tax consequences (such as triggering capital gains on the whole property), we think this technical point should be clarified.

We would be prepared to submit a request for a technical interpretation which would provide the Rulings Directorate with an opportunity to clarify this point.