For the Record

Letter to the Department of Finance Canada re: Draft Income Tax Amendments to Implement 2004 Budget Proposals

The following is a letter from Gavin Wyllie, Chair, National Charities and Not-for-Profit Law Section, Canadian Bar Association, to Len Farber, General Director, Tax Legislation Division, Tax Policy Branch, Department of Finance Canada.

November 9, 2004

Dear Mr. Farber:

I write as Chair of the National Charities and Not-for-Profit Law Section of the Canada Bar Association (CBA Section) concerning the draft legislation released by the Minister of Finance on September 16, 2004 to implement the 2004 budget measures.

I. Comments on Disbursement Quota

A) Introduction

In the CBA Section's submission in April 2003 and our meeting in May 2004 (concerning the February 27, 2004 draft technical amendments and the March 23, 2004 budget), we voiced concern about the increasing complexity of the calculation of the disbursement quota and the technical problems created for charities across Canada. In our April 2004 submission, we repeated the drafting problems we had identified with the disbursement quota, particularly relating to ten-year gifts. We predicted that the continued refinement of the disbursement quota rules would result in more unintended results. As the disbursement quota has become unworkable, we urge Finance to re-think the concept of the disbursement quota rather than attempting to correct specific technical problems.

Notwithstanding the best efforts to draft provisions to correct technical problems with the disbursement quota (particularly relating to ten-year gifts), we are of the view that the draft September 2004 legislation would result in making an already difficult formula virtually incomprehensible, not only for non-professionals, but for most lawyers and, we suspect, accountants.

B) Specific Comments on the Disbursement Quota

Some of the examples of our concerns are listed below:

1. Definitions

i. The definition of "disbursement quota" in subsection 149.1(1) of the *Income Tax Act* excludes from factor "B" in the formula "an amount that is a specified gift or an enduring property." Since a ten-year gift is now part of an enduring property but could also be included as part of a specified gift, either intentionally or unintentionally, there should be a corresponding exclusion of the enduring property that was transferred as a specified gift under factor "A.1" of the formula. However, the proposed wording of factor "A.1" refers only to enduring property that was *received* by the charity as a specified gift, not property that was *transferred* by the charity as a specified gift. As a result, the problem that we originally identified involving the transfer of ten-year gifts to charitable foundations and the unintended increase in the disbursement quota of the transferor charity would continue.

ii. In our earlier submissions, the CBA Section pointed out that capital gains accruing on ten-year gifts could not be expended contrary to how most foundations were dealing with investments, particularly with regard to their investment in mutual funds. We had expected that the draft legislation would provide charities with the ability to expend realized capital gains on ten-year gifts as a matter of right. However, in the draft legislation, the definition of the "capital gains pool" and its inclusion in factor "A.1" in the disbursement formula in subsection 149.1(1) means that the concept of the "capital gains pool" is being used to create an artificial cap on the ability to encroach on the original capital of a ten-year gift in order for a charity to meet its 3.5% disbursement quota. It is our view that there should not be a restriction on the ability of a charity to encroach upon the original capital of a ten-year gift in order to meet its disbursement quota, provided that the terms of the gift permit such encroachment. This understanding is in accordance with our earlier submission and also seems to reflect the explanatory notes accompanying the draft legislation concerning "enduring property." In addition, structuring the "capital gains pool" as a cap on the ability to encroach on the disbursement quota will invariably add an additional layer of complexity to the disbursement quota formula that is already overly technical.

2. Complexity

Since the disbursement quota will now apply to charitable organizations (after 2008 for charitable organizations registered before March 23, 2004), every registered charity in Canada will need to understand and comply with the complexities of the revised disbursement quota formula. The CBA Section is concerned that many accountants and lawyers who are not experienced in charitable tax issues may have difficulty mastering the intricacies of the disbursement quota formula, aside from the thousands of volunteers who have no training in accounting or the law. This will result in most, if not all, registered charities across Canada needing expert ac-

counting and/or legal advice to understand and comply with the complexities of the revised disbursement quota. Possibly a *de minimis* amount of investment assets below which a charitable organization could ignore the 3.5% disbursement quota could assist in this regard.

3. Retroactivity

Paragraph 118.1(5.2)(a) of the *Income Tax Act* currently provides that for purposes of determining if a charitable gift has been made, a direct designation of a charity as beneficiary of a life insurance policy or RRSP/RRIF shall be deemed to be a gift made immediately before the individual's death by the individual to the charity. Interpretation Bulletin 2002-0133545 (January 2003) states that the direct designation to a charity would be deemed to be a gift for purposes of section 118.1 when the requirements of subsections 118.1(5.1) and (5.3) are met but would not need to be included in the disbursement quota of the transferee charity. The draft legislation adds that the transfers to a charity of such assets shall be counted in determining its disbursement quota. Paragraph 10(3) of the draft legislation would apply this subsection in respect of deaths that occurred after 1998. This retroactivity may have negative impact on charities that relied on the law as it stood in prior years.

4. Error in Calculation of Disbursement Quota

Susan Manwaring, a member of the Ontario Bar Association, Charities and Not-for-Profit Law Section, wrote to Brian Ernewein of Finance Canada on September 30, 2004 to advise him of what appears to be an error in the calculation of the disbursement quota. An excerpt from her letter is included below:

> The concern which has arisen as a result of our review of the draft legislation is that the formula will require a double count of the amount of an enduring property expended by the charity to meet its disbursement quota obligations in circumstances where it is required to encroach on enduring property as is permitted by the new definition. We believe that this arises because expenditures of enduring property are included in the calculation under the Factor A.2 instead of A.1. The legislation as drafted does not provide the capital gains reduction to expenditures of enduring property under factor A.2 and in circumstances where the public foundation is only expending enduring property to meet the 3.5% disbursement quota required, the failure to deduct that amount will result in an escalation of the disbursement quota in a way which will make it impossible for the charity to meet its obligations.

It is our understanding that Finance has already agreed to attend to this problem.

The CBA Section remains of the view that the disbursement quota has become too complex and unwieldy and cannot be fixed, despite the best efforts to do so. We continue to recommend that the concept of the disbursement quota be

conceptually re-considered and that the disbursement quota provisions in the draft legislation be deferred for further consideration.

II. Comments on Other Aspects of the Draft Legislation

In relation to other aspects of the draft legislation, we have the following concerns:

1. The Definition of "Undue Benefit"

The definition of "undue benefit" in subsection 188.1(5) appears to be unnecessarily broad, particularly in relation to paragraph (b). The exception to the exception of an undue benefit is stated as including situations where "it can reasonably be considered that the eligibility of the beneficiary for the benefit relates solely to the relationship of the beneficiary to the charity." This broadly worded exception may have unintended effects. For example, the provision seems to create an undue benefit where a donor to a church, who is also a member, has a daughter who is to be married but whose eligibility to be married in the church is conditional upon the daughter becoming a member in that church. The definition of "undue benefit" should not result in unintended consequences that could stifle charitable organizations from doing the charitable work that they were created and authorized to do.

2. Revocation Tax

i. The new formula for the revocation tax in section 188(1.1) A (c) makes reference to all income including gifts received in the winding up period from any source. Current section 187.7 includes the definitions in subsection 149.1(1), but not in subsection 149.1(12). The definition of income in subsection 149.1(12) excludes certain gifts, but this will not apply. Unlike the current rule in section 188(1) B, it seems there will be no exception for any gifts, such as gifts for which no receipts are issued. The same issue arises in section 189(6.2)(a)(ii). We assume this is the intended result and the scope is now to be much broader than under the current rules.

ii. After revocation, it is not clear what happens if land subject to a mortgage is transferred to an eligible donee. The fair market value is included in section 188(1.1) A and the amount of the debt is included in section 188(1.1) B, but the time at which the debt is valued is not clear. It seems to be the end of the deemed year-end just before the winding up period starts, which is when the land is valued. The transfer to the eligible donee reduces the penalty amount only by the equity at the time of transfer, where the mortgage is assumed, if the assumption of the mortgage is treated as consideration. There could be a mismatch in values if the amount of the mortgage changes after the winding up period starts.

3. Eligible Donee

i. The definition of eligible donee in section 188(1.3) seems to assume the donee is a registered charity, without requiring it. The relief in B in the formula in section 188(1.1) is for a transfer to an eligible donee in respect of the charity, without saying it is a registered charity that is an eligible donee. The same issue arises in subsections 189(6.2)(b) and 189(6.3). We would prefer the definition to say that an eligible donee in respect of a charity is a registered charity that meets the tests in (a) through (e). This is consistent with the explanatory notes.

ii. As a practical matter, a charity planning to transfer assets to an eligible donee will now likely seek assurance from CRA that the proposed donee is eligible. It will likely not be prudent to rely only on a representation from the donee and it may not be possible to check all of the criteria through due diligence. For instance, the transferring charity will not know if the transferee charity has unpaid tax liabilities. Liability for tax or penalty can arise without an assessment. A charity may not realize it is liable for or has unpaid tax or penalty when it accepts a transfer, thinking it is an eligible donee. If CRA does not post a list of eligible donees on its Web site, a transferring charity will not be able to protect itself. To prevent this, we think the unpaid liabilities should be only those that have been assessed, are not under appeal or objection, and are not subject to suspension or collection under section 225.1 at that time.

4. Penalties

i. The proposed section 189(7) would allow the Minister to assess at any time in respect of an amount that a taxpayer is liable to pay. The revised section 189(8) incorporates other provisions in Part I, including those in section 152(4) and related provisions dealing with reassessments and limitation periods. It seems there may be no limitation periods for any assessment or reassessment of the Part V tax or penalties, if section 189(7) overrides the other provisions. We suggest that section 189(8) should apply notwithstanding section 189(7). Alternatively, and consistent with the explanatory notes, section 189(7) could say that notwithstanding the issuance of any assessment, the Minister can also revoke registration.

ii. Using a ten-year period for assessing penalties for repeat offences seems harsh, particularly where there could be a whole new regime for running a charity with no knowledge of past transgressions. One can easily envision situations in which completely unrelated staff at different times make similar mistakes in good faith. A shorter period may be appropriate.

iii. The new rules imposing a penalty for overstating a receipted amount refer to "the amount in respect of which a taxpayer may claim" a deduction or credit as the benchmark for the penalty in subsections 188.1(7), (8), and (9). An amount "in respect of which" a deduction

or credit can be claimed is vague, and case law establishes that it is extremely broad. If this is intended to refer to any aspect of the fair market value, the advantage, and the eligible amount, so that an error in any of them will be enough to trigger the penalty, it seems overly harsh. We think it would be better if the provision were more explicit.

iv. The rules should allow the pubic to assume a charity is not suspended unless it is posted on a list on the CRA Web site, so donors can check for the status of a charity. This ties in to the concept of eligible donees. Relying on the suspended charity to tell donors of its status seems a bit naïve. A safe harbour for gifts made in good faith after searching a CRA database or otherwise trying to check the status of the charity would be appropriate. We realize that at present a donor bears the risk of making a gift to an entity that is not a qualified donee, but the CRA Web site now at least allows donors to try to check.

v. In section 188.1(5), an exception from undue benefit should make it clear that an advantage as contemplated in the new section 248(31) that reduces the eligible amount of a gift is not also an undue benefit. If subsection 248(30) and related provisions are not enacted, the reference should be to any amount that reduces the amount treated as a gift.

We trust that these comments will be given due consideration before the draft legislation is presented to Parliament.

Yours truly,
Gavin Wyllie
Chair, National Charities and Not-for-Profit Law Section