Recent Tax Developments

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There have been a number of developments in the tax field during the last year. This paper will consider these developments.

1981 Budget

The most important development was the tabling of the Budget in the House of Commons by The Honourable Allan J. MacEachen on November 12, 1981 (as modified by the Release from the Minister of Finance dated April 21, 1982). In November, the view was expressed that the revisions constituted tax reform. Registered charities were not exempted from the proposed changes, some of which were very significant, particularly the proposed inclusion of realized capital gains in the income base of a charitable foundation, 90% of which must be distributed on an annual basis.

If the provisions of the Budget relating to charities had been enacted as proposed, the effect on registered charities and, more so, on charitable foundations would have been profound. Because of the serious consequences that these provisions would have had on the long-term viability of charitable foundations, as well as the significant affects on their recipients, i.e., the operating charities, many interested parties made representations to the Minister of Finance.

As a result of these representations, the Honourable Allan J. MacEachen, Deputy Prime Minister and Minister of Finance, announced revised rules relating to the minimum disbursements for charitable purposes by charitable foundations and to financial transactions between charitable foundations and related persons (see Release dated April 21, 1982 found on page 41). This Release refers to the extensive consultations which had taken place between the Minister of Finance or his Department's officials and representatives of various charitable foundations since the Budget was introduced in the House of Commons on November 12, 1981. It is not clear whether other proposed rules and in particular those proposals affecting operating charities will be modified prior to the enactment of the legislation implementing the Budget proposals.

Under the Release from the Minister of Finance dated April 21, 1982, the Budget proposals of November 12, 1981 have been modified significantly insofar as the proposed rules relating to the tax treatment of charitable foundations are concerned. Specifically, paragraph (d) of Resolution 138 and paragraph (b) of Resolution 139 relating to the increase in the required distribution in respect of non-qualified investments from 5% to 10%, and the inclusion of realized capital gains in the income base, respectively, are to be replaced by a new concept, that of requiring an annual disbursement of an amount at least equal to 4.5 % of the net fair market value of all investment assets (subject to special rules on non-qualified investments). The system is similar to the one currently used in the United States for private charitable foundations. The only other resolution

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relating to registered charities that is affected by the Release is paragraph (c) of Resolution 138 which imposes a penalty tax where deficient distributions have been made, a charitable foundation will be required to pay a penalty tax of 15% of the amount of the deficient distributions and a further 100% if the deficient amount is not disbursed within a reasonable period of time after notification of such a deficiency.

The new disbursement requirement will be effective for fiscal years commencing in 1983. The funds represented by an income reserve claimed by a charitable foundation in the year immediately preceding the year of the implementation will be required to be distributed over 10 years.

We will now comment briefly on the specific proposals of the Budget.

Under the present provisions of the Income Tax Act, charitable gifts made by will are deemed to be charitable donations made in the taxation year in which the donor died. (subsection 110 (2.1))

Such charitable bequests are, therefore, deductible by the taxpayer in the year of his death but only up to a maximum of 20% of the taxpayer's income in the year of death. (paragraph 110 (1)(a)) Many thought these rules were too restrictive and should be changed to encourage people to support charities in their wills. In many cases, a taxpayer may have little income in the year of death, especially if he dies early in the year, or if he has taken advantage of tax shelters, and, therefore, may deduct only a small portion of charitable gifts made in the year of his death. Because he does not have a subsequent taxation year, he is precluded from carrying forward excess donations arising in the year of death.

In response to some of these problems, Budget Resolution 79 extends the one-year carry-forward to five years and proposes that donations that exceed the 20% limit in the year of death be deductible in the preceding year, to a limit of 20%. This proposal is helpful but will not entirely eliminate tax which arises as a result of a deemed disposition of all of the taxpayer's assets on death.

Resolution 81 proposes that for taxation years commencing after November 12, 1981, a registered charity be registered as either a charitable organization or a charitable foundation and, subject to appeal, the Minister of National Revenue be authorized to designate any charity registered on or before November 12, 1981, as a registered charitable organization or a registered charitable foundation. This resolution seems intended to ensure that charities will not in the future be able to manipulate their tax category and avoid disbursement requirements by controlling the amount of income they spend either on their own charitable activities or by way of donations to other charities.

Other changes are proposed by the Budget in the income tax rules affecting charitable organizations and foundations to ensure that the existing requirements for disbursement of their receipts and incomes are not bypassed. Some of the more important proposals include the following:

(i) Paragraph (a) of Resolution 138 proposes that for taxation years commencing after November 12, 1981, each gift (other than a gift which was not made out of the income of the charity) received in the preceding year from a registered charity other than a related charity be included in the receipts of a registered charitable organization or public foundation for purposes of computing the amount required to be devoted to charitable activities or given to qualified donees. This rule, if implemented, will prevent registered charities from avoiding expending amounts received from nonrelated charities on charitable activities. At present, a tax receipt is not issued by a charitable organization or public foundation for amounts received from a charity and is, therefore, not subject to the 80% expenditure requirement. It appears that the Bill when introduced will not permit public foundations to avoid the expenditure requirement by receiving such a donation as a "10-year gift".

(ii) Paragraph (b) of Resolution 138 proposes that a gift received by a registered charity (other than a gift which was not made out of the income of the charity) from a related charity be required to be expended on charitable activities or on gifts to qualified donnees by the recipient charity in the year of receipt. This will effectively prevent charities avoiding the disbursement requirements by making intergroup transfers. Under the present provisions of the Income Tax Act, a charity may, in some cases, avoid the requirement that particular amounts be expended on charitable activities by, for example, transferring such amounts to a related charity in such manner that it becomes capital of the recipient charity. The budget proposal did not define the term "related charity". Given the fact that perceived abuses concerning charities are regulated in Canada by the income tax authorities under the income tax rules, and not by provincial authorities under more flexible trust law, it seems hard to fault this proposal. It is only unfortunate that a rigid rule has to be imposed on all in order to cure a few abuses, and it is to be hoped that the rules will not be unduly restrictive.

(iii) Paragraph (c) of Resolution 138 proposes that a special penalty tax be imposed on amounts not disbursed by a charity as required. Under the present provisions of the Act, the penalty which may be imposed on a charity which does not meet its expenditure requirement is deregistration by the Minister. The proposed penalty tax will be equal to the amount not disbursed by the charity as required.

This paragraph will only apply to charitable organizations as charitable foundations will be subject to other provisions as outlined in the Release dated April 21, 1982. Briefly, a charitable foundation that fails to make the required distribution in a particular year will be subject to a tax of 15% of the deficiency; furthermore, after the charitable foundation has received notification of a deficiency, it will be subject to a further tax of 100% of the deficiency if the required disbursement has not been made within a reasonable specified time period. In addition, there will be rules for a minimum rate of return on non-qualified investments. The failure to produce the required return results in a penalty tax, as yet unspecified.

(iv) Paragraph (d) of Resolution 138 proposes that for the purpose of determining the disbursement quota for a private foundation, the 5% rate be increased to 10% and be applicable to the greater of the cost amount of the property and its fair market value at the commencement of the year. Under the present provisions of the Act, the 5% rate is applicable to the fair market value of the property at the commencement of its year. The proposal, if implemented, would have precluded a charity from disregarding losses or discounting the value of property in determining the disbursement quota for a private foundation.

Under the Release dated April 21, 1982, this proposal was replaced by a new concept. It is now proposed to require a charitable foundation to disburse an annual amount of 4.5% of the fair market value of all investment assets. Although the 4.5% disbursement requirement will apply to all investment assets whether they are qualified or non-qualified, there will be special rules relating to non-qualified investments. Non-qualified investments would be defined as investments in which there is a potential for self-dealing between the charitable foundation and related persons.

Where the investment was made after April 21, 1982, a charitable foundation will be required to receive a rate of return at least equal to the prescribed interest rate on the cost amount of the debt whereas the dividend rate on the cost of shares must be at least two-thirds of the prescribed interest rate. The prescribed interest rate is the interest charged by Revenue Canada on tax arrears and overpayments. If the Budget provision relating to this subject is enacted, the rate will fluctuate every three months as it is based on the average interest rate on 90-day treasury bills during the first month of the preceding quarter. The prescribed interest rate is now 15%.

For investments held on April 21, 1982, the new rules relating to non-qualified investments will be phased in. Commencing in the 1983 fiscal year, the interest rate on non-qualified debt must then be increased by 2% every year until the rate equals the prescribed interest rate. For equity investments, a minimum rate of return of 4% of the greater of cost or fair market value must be earned in 1983 and thereafter the rate must increase by 1% every five years until the rate equals two-thirds of the prescribed interest rate.

The failure to observe these rules on nonqualified investments will result in a penalty tax, as yet unspecified.

(v) Paragraph (e) of Resolution 138 renders the definition of a qualified investment for a private foundation somewhat more restrictive. This will have the effect of expanding those assets which are by definition non-qualified and increasing the disbursement of such investments. The Release has indicated that a special rule will apply in the case of non-qualified investments which will be defined as investments in which there is a potential for self-dealing between the foundation and related persons. Therefore, it appears that the definition of non-qualified property will be restricted to only non-arm's-length investments.

(vi) Under the present provisions of subsection 149.1(9) of the Income Tax

Act, when property accumulated by a registered charity with permission of the Minister is not used for the particular purpose for which it was accumulated such property is deemed to be income. This means that a charitable organization would not have to include any portion of the amount in computing its disbursement requirement. Paragraph (a) of Resolution 139 proposes that where a charity has accumulated property or income with the Minister's consent but does not use such property or income in accordance with the terms and conditions specified by the Minister, the amount will be deemed to be a receipted donation received by the charity and, for the purpose of determining whether the charity has met its disbursement requirement for the purpose of subsection 149.1 (5), the amount will be deemed not to have been expended on charitable activities during the taxation years while it was being accumulated.

(vii) The proposal which could have been expected to have the most impact on charitable foundations is that found in Resolution 139(b). This provision would have required capital gains and capital losses realized by a charitable foundation to be included in the income of the foundation for the purpose of determining its expenditure requirements. This resolution, if it had been enacted into law, could have been expected to result in a serious erosion of the capital bases of foundations especially if inflation continued at its present rate. This proposal has been replaced by the requirement that a charitable foundation expend annually for charitable purposes an amount equal to 4.5% of the fair market value of all of its investment assets.

Under the proposed method, a charitable foundation will be required to expend on charitable activities and/or gifts to qualified donees, an amount equal to at least 4.5% of the fair market value of all of its investment assets. Presumably, administrative expenses but not investment expenses, will be included in this amount. Assets used in the administration or in the charitable activities of a charitable foundation and funds accumulated for a specific purpose (and with the approval of the Minister of National Revenue) will not be included in the base on which 4.5% is calculated.

The failure to distribute the required amount in a particular year will result in the imposition of a non-refundable penalty of 15% of the deficiency and a further 100% if the required distribution is not made within a reasonable specified period of time after notification of the deficiency. The proposed system has the advantage that the type of income, that is interest, dividend or capital gain, is irrelevant insofar as the required distribution and therefore, the distribution of funds for charitable purposes is not susceptible to manipulation which could arise under the present system. The relatively low rate on distribution in comparison to the present rate of return on debt instruments is established to ensure that the capital of charitable foundations is not eroded over a period of years because of inflation and to recognize that a charitable foundation would invest its funds in a balanced portfolio with equities deriving a rate of return less than the rate of interest on debt instruments. It is premature to comment on whether the distribution rate of 4.5% will allow a charitable foundation to keep pace with inflation.

(viii) Another resolution which will have some effect on the operation of registered charities is paragraph (c) of Resolution 139 which provides that where a registered charity receives any gifts from related charities and disburses any amounts to related charities, the amount of such disbursements that will be recognized as gifts by the registered charity to qualified donees be restricted to the amount by which the aggregate of all such disbursements by it in the year to related charities exceeds the aggregate of all such gifts received by it in the year from related charities. This will preclude related charities from avoiding the relevant disbursement requirements by making intergroup transfers.

Income Tax Regulations

Part XXXV of the Income Tax Regulations relating to information required on charitable donation receipts and the various classes of donees required to give such receipts was amended on March 26, 1981, effective for 1981 and subsequent years.

A brief summary of these rules were contained in the previous issue of *The Philanthropist*. On January 21, 1982, Revenue Canada, Taxation issued a release covering the new changes and indicating that certain changes had been deferred until 1982 and subsequent years. A copy of the release may be obtained from Revenue Canada, Taxation.

Revised Information Returns

Recently, forms T2052 (Return of Information) and T3010 (Public Information Return) have been revised. Previous revisions were made in 1979.

The Return of Information (form T2052), a form which is confidential, has not been revised extensively. The changes to the form include a description of any business activities, the calculation of the distribution test of a charitable foundation and the total amount of tuition fees in respect of which charitable donation receipts were given.

On the other hand, form T3010 (Public Information Return), which can be viewed by the public at the District Taxation Office, has been changed extensively. It presents more information relating to both revenue and expenditures to the reader.

Gifts received from other registered charities, net profits from related businesses (including the requirement to insert the gross sales derived from related businesses) and memberships and subscription fees received will be disclosed in the revenue for the fiscal period. On the expenditure side, there is a requirement to attach a list of qualified donees, their addresses, registration numbers (if applicable), and amounts of gifts made by the reporting entity. At the same time, there is a requirement to segregate the costs of charitable programs carried on by the charity. Costs of those which are carried on in Canada are segregated from costs which are incurred for activities undertaken outside Canada. Information is required on the fund-raising costs including fees paid to fund-raising agencies and amounts receivable and/or payable from/to founders, officers, directors, members or entities related to such persons.

From a review of form T3010 it is obvious that Revenue Canada, Taxation has revised the form T3010 in order that more pertinent information will be available both to Revenue Canada, Taxation and the public. As this form is public, a registered charity should be very careful in preparing the form. Furthermore, it should be prepared on the basis that, to a certain degree, it is "a public relations document".

Cancellation of Customs Duty and Federal Sales Tax Exemptions for Educational Publications, Audio-Visual Materials etc.

In the past, charitable organizations in Canada were entitled to exemptions from customs duty and federal sales tax for a broad range of goods that included printed material, sound and video recordings, motion picture films, film strips, slides, photographic reproduction, etc. To qualify for these exemptions, Revenue Canada, Customs & Excise allowed some charitable organizations to be classified as "a society or institution incorporated or established solely for . . . educational or scientific . . . purposes".

However, under the new rules for the federal sales tax and customs duty, Revenue Canada, Customs & Excise is interpreting these words more strictly. Accordingly many volunteer groups that are not established *solely for educational and scientific purposes* have lost tax relief formerly available to them. This means that many goods formerly exempt are now subject to a 9% federal sales tax and customs duty that could exceed 20%.

The federal sales tax changes took place on January 1, 1981. Prior to this date if imported or domestic goods qualified for classification under certain tariff items, they were exempt automatically from the federal sales tax when they were for the use of an organization that was extended the "educational or scientific" status. The exemption from federal sales tax, now outlined in Schedule III, part III, sections 12 and 13 of the Excise Tax Act describes essentially the same goods to be exempt of tax as formerly contained in the customs tariff items. However, for some of the goods, the exemption was changed to limit it to those organizations employed directly in teaching or research for more than 50% of the time. And, additionally, the stricter interpretation with regard to the organizations entitled to the exemption is also being made by the Excise Branch of Customs & Excise. Revenue Canada, Excise has published Excise Communique #66TI *Replacement Exemptions For Goods Formerly Exempted Under Customs Tariff Item 69605-1* that explains the sales tax changes. A copy can be obtained by calling the local Revenue Canada Excise Office or by writing to the Editor, Excise News, Department of National Revenue, Customs and Excise, Ottawa, Ontario K1A 0L5.

The customs change took place on July 1, 1981. In addition to the stricter interpretation concerning the type of organizations that qualify for duty-free status, the scope of the exemption has been narrowed. Duty-free status for many of the items is now limited to goods that are not available from production in Canada. Revenue Canada, Customs has published Memorandum #D49-33 dated July 1, 1981 which outlines the scope of the changes and they are substantial. Copies of this memorandum can be obtained by calling the local Customs and Excise office or by ordering it from the Department of Supply and Services.

Ontario Retail Sales Tax Rebate on Automobiles or Other Vehicles Used for the Physically Handicapped

Effective March 1, 1981 the tax recovery program provided by the Province of Ontario for vehicles used for the physically handicapped was improved substantially. Previously, the retail sales tax could only be recovered if the motor vehicle was significantly adapted to transport the handicapped and the handicapped person was unable to use public transit. The tax recovery program has been broadened to allow recovery of the tax by a designated member of the family of a physically handicapped person and to include persons who are permanently or seriously restricted in their mobility due to the severity of an illness. Religious, charitable and non-profit organizations purchasing motor vehicles to be used to transport physically handicapped people are also entitled to the tax rebate. The new recovery provision is quite broad and could include vehicles needed to transport persons whose mobility is permanently restricted by virtue of arthritis, sight and hearing impairment, mentally retarded children or adults, etc. If you wish further information on the program a copy of their Sales Tax Guide, #STG-25 *Motor Vehicles Retail Sales Tax Rebate For The Physically Handicapped* dated May 1981, may be obtained from the local Retail Sales Tax Branch, Ministry of Revenue, Government of Ontario.

Update on Cases

The refusal of the Department of National Revenue to register the Manitoba Foundation for Canadian Studies as a charity because of its alleged political activities and the threat of the Department to revoke the registration of Renaissance International for the same reason was discussed in previous editions of *The Philanthropist*. It is expected that both cases will be heard by the federal court in 1982.