REVIEW

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CHARITIES AND NOT-FOR-PROFIT

2006 was another significant year for the regulation of charities in Canada. There is no mistaking the fact that charities in Canada are today subject to increased regulation and public review. The major developments in 2006 serve to promote charitable giving and signal an increase in that regulation and public review.

Capital Gain Tax Relief to Encourage Donations

The best news for the charitable sector last year was the Federal 2006 budget announcement that donors will not have to pay tax on the capital gain realized when publicly listed securities are gifted to charitable organizations and public foundations. A similar exemption now applies to gifts of ecologically sensitive land to approved conservation charities. These changes became law on June 22, 2006 and apply to gifts made after May 2, 2006. The provinces have supported this change.

The impact of these measures was seen almost immediately. In May, two very large donations were publicized. Larry and Judy Tanenbaum gifted $50 million in securities to the endowment arm of the UJA Federation of Greater Toronto. Mr. Tanenbaum stated that he hoped the gift would inspire others since the philanthropic funds are desperately needed and have meaningful impact on the community. Second, Peter Munk donated $37 million to the Toronto General Hospital. The hospital stated that Mr. Munk's gift will go to a facility that will "revolutionize the diagnosis and treatment of cardiovascular disease." In October, Joseph and Wolf Lebovic made a $50 million gift to Mount Sinai Hospital to help to address the hospital's highest priorities – quality of care, patient experience, and its academic mission.

For years, the charitable sector had requested these changes in order to encourage donations. While the tax relief does not yet extend to such donations made to private foundations, the Conservative government stated it intends to enact similar relief for gifts to private foundations provided a suitable regime can be developed to prevent inappropriate self-dealing transactions involving individuals who control public corporations and who exercise control over the private foundations to which the shares are donated.

Charities have been taking advantage of these new rules by educating donors and ensuring they have policies in place to accept gifts of securities. While this measure has encouraged large donations, all donors of appreciated securities will benefit from this tax effective giving strategy.

Income Trusts

Charities are not always at the top of the government's mind when drafting legislation. The announcement on October 31, 2006 regarding income trusts had a profound effect on the charitable sector. Before the announcement income trusts were a natural investment for charity, since payments flowed through the trust were not taxed at either the level of the trust or the charity. However, the gross-up mechanism provided to compensate investors for the new level of tax at the trust level does not provide any compensation to charities. Investment Committees will have to now consider whether such investments fit with the organization's investment policies.

Increasing Audits

The charitable sector faced increased audit activity in 2006. The Canada Revenue Agency Charities Directorate estimated that 1% of the over 82,000 registered charities in Canada would be audited last year. The Charities Directorate stated that it hoped the increased audit activity would lead to enhanced compliance with the requirements of the *Income Tax Act* by educating charities.

Unfortunately, the audit program is no longer under the direct control of the Charities Directorate. The local Canada Revenue Agency Tax Services Office tax auditors now conduct charity audits. These auditors may not have as much background in this sector and seem to take the approach that taxpayers (*i.e.* the charities) under audit have been chosen for a reason and are likely to be non-compliant. Therefore, these auditors are proposing to revoke charities in situations that would not have resulted in revocation in the past.

Despite the fact that most charities are resolutely focusing their efforts on fulfilling their charitable purposes, few organizations come through an audit with a clean slate. Historically 25% of organizations have issues with record keeping, 25% have incomplete information, 10% have gifted to non-qualified donees, 10% have lost touch with their original charitable purpose and the remainder face a variety of other issues.

Upon receiving notification of audit, organizations should obtain legal advice on how to approach the audit and issues which may arise.

Tax Shelters – Charitable Giving Scrutinized

Tax shelters using charitable donations have also been the focus of increased audit activity. Tax shelters are defined in the *Income Tax Act* to include any property acquisition or gifting arrangement where it is represented that a purchaser or donor may claim tax benefits and deductions that are equal to or exceed the net cost of the property or entering into the arrangement. An example of one type of tax shelter that has come under attack from the Canada Revenue Agency ("CRA") in recent years is that involving buy-low, donate-high charitable giving. This type of tax shelter involves a situation where a taxpayer buys a quantity of goods, such as artwork or comic books, without taking possession of them, through a promoter. The promoter arranges to have the goods appraised and locates a registered charity to which the taxpayer can donate the goods. The charity issues a tax receipt for an amount considerably higher than what the taxpayer paid for the donated goods, and the result is a tax credit to the taxpayer greater than the price paid. CRA is of the view that because such donations are generally made soon after the purchase of the goods, there is little justification for claiming the substantial increase in value based on appreciation or a change in supply and demand. This view was accepted by the courts in a series of "art-flip" cases heard in 2005 and 2006.

Of particular note is the April 2006 decision of the Supreme Court of Canada to dismiss two applications to hear an appeal of the Federal Court of Appeal decisions involving "art flipping" arrangements. The cases of *Klotz v. R.* [2005] 3 CTC 78, and *Quinn v. R.*, *Tolley v. R.*, and *Nash v. R.* (these latter three all heard as Canada *(Attorney General)* v. *Nash et al.* 2005 FCA 386, (2005), 344 N.R. 152) involved situations where the taxpayers bought and donated art through tax shelter promoters and claimed tax credits that far exceeded the purchase price paid by the donors. The Federal Court of Appeal held that the best evidence of the fair market value of the art is what the donor paid for it.

2006 also saw CRA taking a more active role in warning taxpayers about the risks related to participating in certain tax shelter gifting arrangements since November 2003. In an October 31, 2006 news release and November 2006 "Taxpayer Alert," CRA reminded taxpayers that there are financial risks inherent in gifting trust arrangements, leveraged cash donations and buy-low, donate-high arrangements. CRA also warned taxpayers that although donation arrangements that are tax shelters must have tax shelter identification numbers issued by CRA before promoters can sell them, the existence of a tax shelter number was not a guarantee that taxpayers will receive the proposed tax benefits. The tax shelter number simply allows CRA to identify all tax shelters and their investors.

CRA reviews all tax shelters to ensure that they comply with the *Income Tax Act.* Prior to 2002, CRA disallowed about $490 million in donations from 6,700 taxpayers and for 2002, $360 million from 5,700 taxpayers. For the 2003 tax year, CRA reports that it has so far disallowed $66 million in donations from 1,800 taxpayers.

BY KATE LAZIER AND MONIQUE P. TRÉPANIER