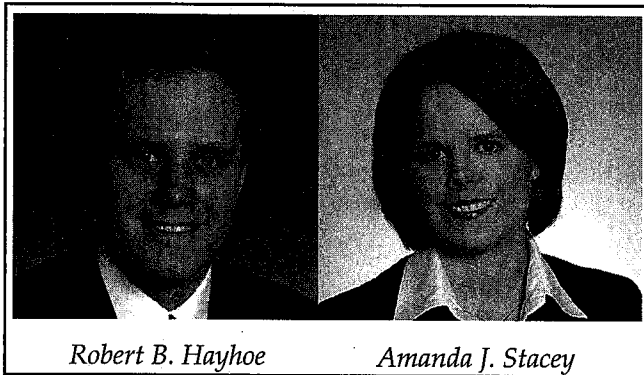


The Continuing Saga of Charitable Donation Tax Shelters in Canada

by Robert B. Hayhoe and
Amanda J. Stacey



Robert B. Hayhoe is a charity tax partner and Amanda J. Stacey is a charity tax associate with Miller Thomson LLP in Toronto.



In the April 2004 edition of this publication, Robert Hayhoe reported on the state of charitable donation tax shelters in Canada.¹ In the past four years, the Canadian courts, charities, and donors alike have continued to grapple with attempts by the Canada Revenue Agency to shut down the various charitable donation tax programs that have been created in Canada. In particular, the CRA has targeted donors, charities, tax shelter promoters, and professional advisers involved in the schemes. Donors and charities have had limited success before the courts, and charities are now faced with very aggressive opposition from the CRA if they have had any involvement with a donation tax shelter.

This article will examine the state of tax shelter opposition today and, in particular, the CRA's audit policy on the issue.

¹Robert B. Hayhoe, "The End of Charitable Donation Tax Shelters in Canada?" *The Exempt Organization Tax Review*, Apr. 2004, p. 69.

The State of Bulk Valuation

As reported in the 2004 article, the Tax Court of Canada in *Klotz v. The Queen*,² a case that involved a donation of a large number of fine art prints as part of a valuation-based donation program, held that bulk pricing should be applied for the purpose of the donation valuation. The decision was upheld on appeal.³ Since the decision, the Tax Court of Canada has been faced with a number of similar appeals involving "buy low, donate high" schemes.

In the decision of the Federal Court of Appeal in *The Queen v. Malette*,⁴ the court extended the application of the bulk valuation principle to gifts of Canadian cultural property certified under the Cultural Property Export and Import Act.⁵ Before the decision, the case law had suggested that this principle would not apply to such property.

Interestingly, the taxpayer prevailed in the decision of the Tax Court of Canada in *Quinn v. The Queen*.⁶ In that case, the court distinguished between the *Klotz* and *Malette* decisions and accepted the taxpayer's appraisals of the prints in question, noting that they were of much better quality than those introduced in *Klotz*. However, the CRA believes that this case can be distinguished on the basis that the Crown did not introduce evidence regarding valuation of the prints. On the CRA theory, the case does little more than confirm that valuation evidence must be presented in each case and that the court will not apply a block discount as a matter of course without proper evidence.

Tax Shelter Donations and the Definition of a Gift

In late 2006 in *McPherson v. The Queen*,⁷ the CRA challenged a donor's gift to the Association for the Betterment of Literacy and Education, a charity that was deregistered on September 25, 1999, and that has been the subject of more than one tax shelter case.⁸ The donor

²2004 TCC 147 [*Klotz*].

³2005 D.T.C. 5279 (FCA).

⁴2004 D.T.C. 6415 [*Malette*].

⁵R.S., 1985, C. C-51. A donation of certified cultural property to a designated institution or a public authority under this legislation has special benefits to a donor: (1) the donation is not limited to a percentage of the donor's net income and (2) the donor does not have to pay tax on any capital gains realized on the transfer of that property to a designated institution or a public authority.

⁶2004 D.T.C. 3328.

⁷2007 D.T.C. 326.

⁸See also *Norton v. Canada* 2008 D.T.C. 2701, *Doubinin v. Canada* 2005 FCA 298, and *Webb v. Canada* 2004 TCC 619, each

(Footnote continued on next page.)

participated in a scheme that appears to have involved an explicit kickback to the donor of 75 percent of the value of his gift. The donor received an official donation receipt for 100 percent of the value of the donation. The court held that this kickback feature robbed the donation entirely of its character as a gift. Given the court's finding that the donor made his donation with the expectation that he would receive the 75 percent kickback, the donation did not meet the definition of a gift and thus the donor was not entitled to an official donation receipt (even for the net 25 percent contributed by the donor). His donation lacked the required element of impoverishment, the kickback vitiated any charitable intent, and the donor received consideration for his donation.

Interestingly, the case does not follow the earlier decision of the Federal Court of Appeal in *The Queen v. Friedberg*⁹ wherein this doctrinal approach to determining whether a gift in the charitable sense had been made was rejected by the court.

Introduction of Intermediate Sanctions Under the Income Tax Act

The 2004 Federal Budget introduced extensive changes to charity tax law in Canada. In particular, the budget introduced new intermediate sanction taxes and penalties applicable to charities.¹⁰ Before this budget, the CRA was only able to police the charity tax system by revoking charitable registration. Because revocation was such a serious sanction, it was often difficult for the CRA to apply and it sometimes resulted in charities behaving like they were not subject to CRA regulation.

The new rules apply to noncompliance occurring during a charity's fiscal period beginning after March 22, 2004. Essentially, the changes introduced two types of penalties other than revocation: financial penalties and suspension of a charity's right to issue official donation receipts. According to guidelines published in April 2007, in most cases the financial penalty will be the first sanction applied to a charity; repeated infractions will result in either more severe financial penalties or a suspension of the charity's right to issue receipts.

CRA Application of Intermediate Sanctions and Threats of Revocation

On August 15, 2007, the CRA issued a news release urging Canadian taxpayers to be wary of promotions of tax shelter gifting arrangements promising huge tax savings. The CRA confirmed that it was auditing all tax shelter gifting arrangements, reporting that as of the date of the news release it had audited more than 26,000 individuals who had participated in donation tax shelters, that it would soon complete audits of another 20,000 taxpayers, and that it would soon commence auditing

involving a challenge to a donor's gift to the Association for the Betterment of Literacy and Education.

⁹92 D.T.C. 6031 (upheld by the Supreme Court of Canada on other grounds, 93 D.T.C. 5507).

¹⁰See Robert B. Hayhoe, "Canadian Federal Budget Introduces Intermediate Sanctions," *The Exempt Organization Tax Review*, May 2004, p. 185.

another 50,000 taxpayers. In a taxpayer alert released the same day, the CRA cautioned donors not to rely on tax shelter identification numbers as a guarantee of a tax shelter's acceptance by the CRA.

It has been our experience that the CRA is indeed auditing all charity participants in tax shelter donation schemes, not just the receipt-issuing charities.¹¹ However, the CRA's aggressive approach goes even further. The CRA is proposing and applying intermediate sanctions, and in particular, it is suspending the receipt-issuing privileges of charities found to be involved in donation tax shelters. This is in spite of the CRA's statement in the April 2007 guidelines that a suspension would not likely be used as a first penalty. Also, the CRA has revoked the registration of a couple of charities and is now trying to force through revocation of others even before all appeal routes have been exhausted.

Suspension of Receipting

On November 21, 2007, the International Charity Association Network (ICAN) was the first charity to be sanctioned publicly under the intermediate sanctions rules. The CRA contended that ICAN had breached sections of the Income Tax Act by "failing to maintain and/or provide, and failing to provide access to, books and records relating to its involvement with tax shelter arrangements."¹² Counsel for ICAN appeared in court on December 10, 2007, seeking a postponement order until an appeal had been heard. However, the Tax Court of Canada merely took the matter under advisement and did not grant the postponement.

On January 3, 2008, the Tax Court of Canada dismissed ICAN's application to postpone its receipting suspension.¹³ The court held that an application for postponement of a suspension requires that a charity satisfy the three-part test for interlocutory injunctions set by the Supreme Court of Canada in *RJR-MacDonald v. Canada (A.G.)*.¹⁴ This test provides that the applicant must demonstrate: (1) that there is a serious question to be tried; (2) that it would suffer irreparable harm if denied the injunction; and (3) that the balance of convenience favors granting the injunction.

¹¹The CRA's audits of charities involved in tax shelters have also become confrontational and aggressive beyond anything ever experienced by Canadian registered charities. Perversely, it may be that in some cases, the CRA's behavior may be so aggressive that it will actually allow charities to escape revocation of registration. The Federal Court of Appeal has already indicated that when the CRA does not comply with the duty of fairness that it owes a charity under audit, the CRA will be precluded from revoking registration: *Re Renaissance Int'l. v. MNR* (1982), 142 D.L.R. (3d) 539, 83 D.T.C. 5024; [1982] CTC 393 (FCA).

¹²CRA news release: "CRA Issues Notice of Suspension to International Charity Association Network." Available at: <http://www.cra-arc.gc.ca/newsroom/releases/2007/nov/nr071129-e.html>.

¹³2008 TCC 3.

¹⁴[1994] 1 S.C.R. 311.

The Tax Court of Canada held that ICAN had not proven that it would suffer irreparable harm if its receipting powers were suspended, even though a charity's ability to issue receipts is crucial to its ability to operate and the loss of that right would lead, we would expect, to an irreparable loss of donor confidence. Also, the court held that the balance of convenience favored the CRA and argued that public confidence would be harmed if the CRA were unable to administer the provisions of the Income Tax Act and ensure compliance in the public interest. The court did find that there was a serious question to be tried.

Revocation Publication — ICAN's Troubles Continue

On December 3, 2007, the CRA issued ICAN a notice that it intended to revoke its charitable status. A revocation becomes effective once it is published in the *Canada Gazette* (the official newspaper of the government of Canada.) In the past, CRA would routinely agree to postpone *Gazette* publication of a charity's revocation until appeal rights were exhausted. However, in the ICAN case (and in other similar matters of which we are aware), the CRA refused to delay publication despite appeals being planned or in progress. ICAN brought an application in the Federal Court of Appeal to stay the publication of revocation in the *Gazette*; however, the application was dismissed on April 2, 2008.¹⁵ To date, ICAN is subject to a suspension of its receipting privileges and its qualified donee status.

In a similar move the CRA announced on March 5, 2008, that it had revoked the charitable status of the Francis Jude Wilson Foundation for its participation in receipting charitable donation shelter gifts. The foundation's revocation was published in the *Gazette* and thus became effective on February 23, 2008.

¹⁵2008 FCA 114.

Donor Civil Action

In February 2008 two donors commenced a class action suit against the Banyan Tree Foundation (as well as the promoters and their law firm) on behalf of all donors to the Banyan Tree Gift Program, a charitable donation tax shelter that has been the subject of a recent CRA investigation.¹⁶ The plaintiffs are seeking compensation for the costs of their individual reassessments by the CRA as well as recovery of the funds they paid into the tax shelter.

This claim is the first of its kind in Canada. Although it has yet to be certified by the Ontario courts, it no doubt exposes charities participating in charitable donation tax shelters to another source of risk.

Conclusion

It seems that the CRA is keeping true to its promise to aggressively audit and sanction charities involved in charitable donation tax schemes. Unfortunately for the charities involved, so far they have been granted little assistance from the courts in responding to the CRA's tactics. Given the pervasiveness of the use of charitable donation tax shelters in the past few years, the cases discussed here are likely only the tip of the iceberg. It will be interesting to see how the law governing charity audits and appeals develops in this context — it would be a great pity if the tax shelter context drove the courts to erode inadvertently the legitimate procedural protections afforded to all charities.

¹⁶See <http://www.cbc.ca/canada/story/2008/05/30/f-ban-yancharity.html> for a press report. The Statement of Claim (as yet not certified as a class action) is available at <http://www.classactionlaw.ca/content/claims/Rochester/Rochester.htm>.