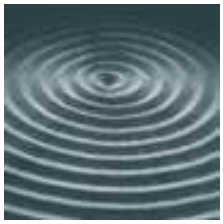
2500, 20 Queen St. West
Toronto, ON
Canada
M5H 3S1
Tel. 416.595.8500
Fax 416.595.8695
www.millerthomson.com



M I L L E R T H O M S O N L L P

Barristers & Solicitors, Patent & Trade-Mark Agents

TORONTO VANCOUVER CALGARY EDMONTON WATERLOO-WELLINGTON MARKHAM WHITEHORSE WASHINGTON, D.C.

The end of charitable dontation tax shelters in Canada?

Robert B. Hayhoe

April, 2004

The End of Charitable Donation Tax Shelters in Canada?

by Robert B. Hayhoe

Robert Hayhoe practices charity tax law with Miller Thomson LLP in Toronto, Ontario, Canada.

Over the past few years, the promotion of charitable donation programs with tax shelter elements has exploded. The Canada Revenue Agency[1] (Canada's tax administrator), the Department of Finance (responsible for Canadian tax policy and tax legislation), and the Tax Court of Canada (Canada's trial court for most tax appeals) have all played a role in combining to try to close tax shelter donation programs. This article will examine the role played by each government actor in apparently putting a stop to charitable donation tax shelters in Canada.

Canadian Tax Treatment of Charitable Donations

To properly understand Canadian charitable donation shelters, it is necessary to understand the Canadian tax treatment of donations.[2]

Canadian resident individuals receive a non-refundable tax credit for gifts to a qualified donee. The tax credit (for gifts of more than $200 per year) is more or less equal to the tax that would have been paid if the donor was a top marginal rate taxpayer. Canadian resident corporations are eligible for a deduction in computing taxable income equal to gifts to a qualified donee. The *Income Tax Act* (Canada) defines "qualified donee" to include various entities, the most important of which is a Canadian registered charity, although a Canadian municipality (which may include an Indian band) and a foreign university prescribed as being one customarily attended by Canadians also meet the definition.

Canada taxes capital gains on a realization basis. The gift of a piece of property gives rise to a deemed realization. However, the first $1,000 of gain on "personal use property" is exempt from tax. Furthermore, only 50 percent of any capital gain is taxable. Gifts of property are valued (for both tax credit/deduction purposes and capital gain purposes) at fair market value, a concept that is not defined by statute or regulation.

Canada has had a tax shelter registration system for a number of years. A transaction that resulted in certain particularly large tax deductions was defined to be a tax shelter that was required to be registered. Absent registration, the resulting deductions were denied and various penalties were applied.

Recently Available Charitable Donation Tax Shelters[3]

Buy Low — Donate High

The most common Canadian charitable donation programs were valuation-based. They involved programs whereby donors could purchase goods (artwork, basic foodstuffs, and medical supplies were popular) from promoters/fundraising consultants at wholesale or even firesale prices. These same goods could then be donated to particular qualified donees — these qualified donees would issue donation receipts at retail value (backed by professional valuations arranged by the promoters). The resulting tax credit or deduction would, by design, exceed the cost of the donated goods such that the gift would be profitable on an after-tax basis.

Initially, valuation-based donation programs all involved the donation of goods that could be characterized as multiple items of personal use property. As such, while an individual donor would claim a full-value tax credit, the donor would not report a corresponding income inclusion as a result of the capital gain that arises in the short interval between the purchase of the goods at wholesale and the donor's immediate donation at retail.

[1]Until recently, the Canada Customs and Revenue Agency and formerly Revenue Canada.

[2]For a slightly more complete outline aimed at non-Canadians, *see* R. Hayhoe, "An Introduction to the Canadian Tax Treatment of the Third Sector" (2004) 6:2 *IJNL* http://www.icnl.org/JOURNAL/vol6iss2/ar_hayhoe.htm. The only current Canadian charity tax text is A. Drache, *Canadian Taxation of Charities and Donations* (Toronto: Carswell, looseleaf).

[3]For a more detailed description of charitable donation (and other) tax shelters in Canada, *see* Graham Turner, "Tax Shelters — Past, Present and Future," (2003) 1654 *CCH Tax Topics* 1.

Leveraged Donations

The second common type of charitable donation program (known as a leveraged donation shelter) involved a fundraiser/promoter arranging for a loan to a donor to enable the donor to make a charitable gift. At the same time, the donor invested an amount into a fund where the yield generated would enable the funds to grow during the loan term into an amount equal to the loan payable. The initial versions of the leveraged donation program involved interest-free loans to donors. These programs were advertised (including on radio spots!) as being superior to buy low-donate high programs because of the absence of a valuation issue.

Individual donors to a leveraged donation program would claim an immediate tax credit equal to the full amount of the gift (made up to a very limited extent of their own cash and largely of borrowed cash). While they would have to pay tax on their share of the sinking fund's income, the programs offered a very significant deferral benefit.

Canadian Government Responses to Charitable Donation Tax Shelters

Definition of Gift

The initial response of the Canada Revenue Agency to valuation-based shelters was to deny donation claims on the ground that the donations did not involve gifts at law because they were motivated by tax benefit rather than philanthropy. The Federal Court of Appeal disagreed with this approach in *The Queen v. Friedberg*.[4]

Flawed Valuations

The Canada Revenue Agency was able to attack, with some success, many of the less sophisticated valuation shelters on the basis that the valuations were defective or had been prepared by the promoters (for example, see *The Queen v. Duguay*[5]). However, this approach was not always available and, in any event, required a separate attack on each donation program.

Amendment of Personal Use Property Definition

In 2000, the Department of Finance made its first legislative attempt to end valuation-based donation programs. The attempt was made to do so through the introduction of *Income Tax Act* amendments that denied the $1,000 capital gains exemption for personal use property acquired from a promoter for the purpose of making a donation.[6] This amendment had very little impact on the market for valuation-based programs, which continued to grow. In fact, the only real impact of the change was that the wholesale prices at which goods were sold to prospective donors dropped by an amount large enough to make the gifts cash-flow positive to donors even with the payment of tax on the now taxable capital gain.

Amendment of Tax Shelter Definition

The next legislative attack on valuation-based donation programs was an amendment released in 2003 that changed the definition of tax shelter to include situations where tax is saved by way of a tax credit as well as a deduction from income.[7] This change had the effect of requiring valuation-based donation programs to seek out a tax shelter identification number that enabled the Canada Revenue Agency to track donation-based shelters and deny claimed donation tax credits on a systematic basis. The change had little impact on the volume of donations.[8]

Imposition of Hold Period

The final legislative attack on valuation-based shelters occurred on December 5, 2003 when *Income Tax Act* amendments were announced that purport to prevent a donor from obtaining tax recognition for the portion of the value of a claimed non-cash donation that exceeds the donor's cost for the donated property unless the donated goods were obtained more than three years ago and with an intention other than to donate the goods.[9] Excluded from these new rules are donations of inventory, public securities, certified cultural property, ecological property, and real property in Canada, as well as gifts at death.

It appears that this proposed amendment, which contains a broad anti-avoidance rule, will prove effective (not to doubt the ingenuity of tax shelter promoters . . .).

Tax Court of Canada Requires Bulk Valuation

In early 2004, the Tax Court of Canada decided *Klotz v. the Queen*,[10] which involved a donation of a large number of fine art prints as part of a valuation-based donation program.[11] The court accepted the Crown's valuation approach that the market for art for donations was so large that it formed its own market. This valuation theory was based on a series of U.S. Tax Court cases that had come to this conclusion in exam-

[4]92 D.T.C. 6031 (upheld by the Supreme Court of Canada on other grounds, 93 D.T.C. 5507).

[5]2000 D.T.C. 6620 (F.C.A.)

[6]Subsection 46(5).

[7]Section 237.1.

[8]Indeed, Graham Turner, *supra* note 3 at p.4, suggests that the change actually resulted in an increase in volume!

[9]Proposed subsection 248(35).

[10]2004 TCC 147.

[11]Interestingly, the Klotz donations were to the University of Florida, which is a qualified donee for Canadian tax purposes. It appears that some promoters of these programs arranged specifically that the prints would be donated to non-Canadian qualified donees, perhaps on the theory that the *Income Tax Act* gives the Canada Revenue Agency no practical ability to oversee their issuance of charitable donation receipts.

ining similar programs that had been promoted to U.S. donors. The court concluded that this tax shelter market is a bulk market and bulk pricing should be applied. While the court acknowledged the existence of a specific U.S. tax regulation (with no Canadian counterpart) requiring that donation valuation be on the basis of the market in which the item is "most commonly sold to the public," the decision placed little importance on this distinction.

The court in *Klotz* decided that the best evidence of the value of the prints in the tax shelter market was the amount paid by the donor. The result of this finding was that Mr. Klotz's donation ended up costing him the difference between the amount paid for the donated prints and the tax saving of about 45 percent of that amount. Although the *Klotz* decision is almost certain to be appealed, it suggests that many valuation-based donation programs may not have been effective even absent the various statutory amendments designed to curtail and prevent their use.

Reduction of Gift by Borrowed Amount

Leveraged donation programs are newer and have not yet been examined by a court. However, they have been the subject of legislative attack. These leveraged donation shelters were addressed previously by the Department of Finance in draft legislation issued in December of 2002, modified first in February of 2003 and again in December of 2003. The current draft legislation clarifies that, effective February 18, 2003, the amount of a donation is reduced by any amount borrowed to make the gift if the borrowing is limited recourse (defined broadly).[12] An amount owing is deemed[13] to be limited recourse unless there are *bona fide* written arrangements to repay the debt within 10 years and interest is paid annually within 60 days of the donor's year end and at least at the Canada Revenue Agency's prescribed rate.

The loans that are typically used in leveraged donation programs appear to be caught by the definition of limited recourse. As a result, these proposed amendments look like they will end the use of leveraged donation programs.

Conclusion

As a result of the changes described above, it appears that most currently available mass-market charitable donation tax shelter programs have been shut down in Canada. It will be interesting to watch and see if promoters and their advisors will be able to resurrect donation shelters.

[12]Proposed subsections 248(30)-(31).

[13]By proposed subsection 143.2(7).