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CHARITIES & NOT-FOR-PROFIT NEWSLETTER

The Charities & Not-for-Profit Newsletter is published monthly by Miller Thomson LLP's Charities & Not-for-Profit Group as a service to our clients and the broader voluntary sector. We encourage you to forward the e-mail delivering this newsletter to anyone (internal or external to your organization) who might be interested. Complimentary e-mail subscriptions are available by contacting charitieseditor@millerthomson.com.

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BUDGET 2009 – DISAPPOINTMENT FOR THE VOLUNTARY SECTOR

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Finance Minister Flaherty tabled his much discussed budget on January 27, 2009 after widespread consultation with Canadians. This Budget is critical to the survival of the Government and as we write, the Liberals have not announced whether they will support the initiatives announced or vote against it.

Budget 2009 contains a bit of something for many Canadians and is therefore likely to be supported. What it does not contain are any proposals for changes to the *Income Tax Act* (Canada) or *Excise Tax Act* (Canada) designed to stimulate an increase in donations to charities or minimize the cost of GST which charities bear.

Submissions had been sent to the Minister of Finance and the Prime Minister that included proposals to increase the tax credit available on charitable donations either in a time limited manner or permanently; proposals to increase the rebate charities receive for GST they pay to 100%; and proposals to eliminate the capital gains tax paid on gifts to charity of private company shares or real estate – all of which were tabled as recommendations to protect the critical support charities receive from individual Canadians that enables them to do the work they do to help the most vulnerable living among us. None of these recommendations were adopted. In fact, the Budget does not appear to have made any reference to the collective charitable sector at all.

Budget 2009 does target funding to groups within the sector at different levels. Infrastructure programs will support certain initiatives of First Nations and provide support for colleges and universities, and the budget contains limited funding for sports, heritage and cultural programming and increases funding for social housing. These programs are welcome and will help these groups continue to provide the support to Canadians in need during these economically difficult times.

The Charitable and Not for Profit sector is a valuable pillar, critical to the fabric of Canadian society. We had hoped to see stimulus measures which would have led individual Canadians who have the ability to increase their support to ensure the continued stability of charities in our communities. We hope the Government is correct in its optimism about the length of the recession If not, we hope we will see these initiatives introduced in Budget 2010.

LEGAL LESSONS FROM THE MADOFF SCANDAL

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As has been widely reported in recent news, the United States Securities and Exchange Commission is investigating Bernard Madoff and his broker-dealer and investment adviser business, Bernard L. Madoff Investment Securities LLC. Madoff allegedly confessed to his sons that he had been operating a $50 billion Ponzi scheme. A Ponzi scheme is a fraudulent investment operation that pays returns to earlier investors out of the money paid by new investors rather than from profit.

In the United States, several charitable organizations have suffered losses estimated as high as $600-million. The prominent losers included Yeshiva University and the Elie Wiesel Foundation for Humanity, which lost tens of millions of dollars. In Canada, only one investor has admitted to a loss in the alleged fraud scheme run by Madoff. The Jewish Federation of Greater Toronto lost $486,000, which represents a small fraction of its $200-million endowment assets. The Toronto-Dominion Bank and the Royal Bank of Canada have revealed that their clients lost $5-million and less than $50-million respectively, but those investors have not been identified publicly. The banks did not have their own investments with Mr. Madoff's fund.

Undoubtedly, Madoff's frank admissions will help the victims of the fraud pursue successful claims. However, the funds available to compensate victims are inadequate.

Investors in the Madoff scheme may have recourse in the Securities Investor Protection Corporation ("SIPC") in the United States, which covers up to $500,000 of losses incurred by customers of failed SIPC member brokerage firms.

If a similar scheme had occurred in Canada, the Canadian Investor Protection Fund ("CIPF") protects investors in the event that an investment dealer becomes insolvent. CIPF ensures that the cash and securities of "eligible investors" of investment dealers are protected. The investment dealer must be a dealer member ("Member") of the Investment Industry Regulatory Organization of Canada. Since CIPF's creation in 1969, 17 Members have become insolvent, and all eligible investors have recovered their assets.

CIPF compensates "eligible investors" who have suffered or may suffer financial loss solely as a result of the insolvency of a Member. Such loss must be in respect of a claim for the failure of the Member to return or account for securities, cash balances, commodities, futures contracts, segregated insurance funds received, acquired or held by the Member in an account for the customer.

The following losses are not eligible for payment by CIPF:

- Losses which do not result from the insolvency of a Member;
- Losses in accounts of customers related to business financing purposes of a Member;
- Losses where the customer has not filed a claim with CIPF within 180 days of the date of insolvency; or
- Losses relating to securities or segregated funds that are not held by a Member, or recorded in a customer's account as being held by a Member.

CIPF maintains a list of "eligible investors" that are entitled to protection. An "eligible investor" is any customer having a securities or commodity or futures contracts account with a Member used solely for the purpose of transacting securities or commodity and futures contracts business. Such accounts must be fully disclosed in the records of the insolvent Member and are typically evidenced by receipts, contracts and statements that have been issued by the Member.

An "eligible investor" may be an individual, a corporation, a partnership, an unincorporated syndicate, an unincorporated organization, a trust, a trustee, an executor, an administrator or other legal representative. However, certain persons are not considered "eligible investors", including any person who owns in aggregate five percent or more of the capital of the insolvent Member consisting of equity securities of any class

and/or subordinated debt of the Member, and a person who caused or materially contributed to the insolvency of the Member.

A limit has been placed by CIPF on the coverage provided for an eligible investor's account equal to $1 million for losses of securities, commodity and futures contracts, segregated insurance funds and cash.

Miller Thomson LLP has lawyers specializing in securities law that can assist investors that are affected by the Madoff scheme or the insolvency of other dealers. We are also available to provide proactive advice advise on specific large investments.

COURT UPHOLDS CRA REVOCATION OF CHARITY REGISTERED IN ERROR

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In December 2008, the Federal Court of Appeal upheld a decision to revoke the charitable registration of Hostelling International Canada – Ontario East Region ("Hostelling International"). The charity's purpose was to advance education by providing affordable accommodation for young people seeking to gain greater exposure to other parts of the world. The decision is unfortunate in part because the Court permitted revocation (rather than annulment) of a charity's registration which was made in error.

The *Income Tax Act* (the "Act") provides two basic means by which CRA may cause a charity to cease to be registered. One familiar approach is revocation of registration. This entails a loss of charitable status and the imposition of the revocation tax, which requires that the charity pay a tax equal to the value of all its property as of the date on which the charity receives notice of intent to revoke charitable registration. Alongside the intermediate sanctions, revocation is available as a penalty where a charity engages in serious, culpable non-compliance with the provisions of the Act.

The second approach is annulment. The Act provides CRA with the discretion to annul a charity's registration where the charity has been registered in error, or has, solely as a result of a change in the law, ceased to comply with the Act. When a charity's registration is annulled, the Act deems it never to have been registered in the first place. The significant difference between annulment and revocation is that annulment does not entail imposition of the revocation tax. Furthermore, all receipts issued prior to annulment are deemed valid. This approach is designed for cases in which a charity was properly registered by CRA and has committed no serious misconduct, but where as a result of a change in the law (usually relating to the definition of 'charity'), the charity's duly registered purposes and/or activities are no longer recognized as charitable.

This was arguably the case with Hostelling International. The charity had been registered twice as an education charity and had been carrying out activities in accordance with its charitable objects. However, subsequent to the charity's registration, CRA took the position (and the Federal Court of Appeal agreed) that the provision of affordable accommodation with associated educational programming was not charitable, with the result that the charity was not longer devoting all resources to charitable activities. The charity argued that this should result only in annulment, rather than revocation. However, the Court simply stated that because CRA had proceeded by way of revocation, it was open to CRA to revoke.

This decision is unfortunate in that it suggests that CRA may disregard the annulment provision and seek revocation whenever it chooses, even if the charity has ceased to comply entirely as a result of factors beyond its control. Charities now risk being "trapped" into registration with objects that cease to be charitable, resulting in the revocation tax being imposed on those charities. It may be hoped that future cases will set out rules which will limit CRA's discretion to revoke where the annulment provision would apply – for example, that the decision to revoke rather than annul cannot be exercised punitively and should be used only rarely (if ever) where annulment is available. We hope that CRA will not be aggressive in seeking revocation where annulment is appropriate, and that it will permit charities registered in error to be annulled, or to amend their objects as necessary, without being subjected unfairly to sanctions.

NEW CANADA REVENUE AGENCY TECHNICAL INTERPRETATIONS - BARTER DOLLARS AND COTTAGES

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The Canada Revenue Agency (the "CRA") has recently released two Technical Interpretations concerning charitable gifts. In the first interpretation, released September 25, 2008 (Document No. 2008-027441I7), the principle issue was whether a unit of barter dollars is an eligible property for the purposes of the charitable gifts rule. The individual donor was a member of a recognized barter club. He donated units of barter dollars having a certain face value to a registered charity. The units would have been acquired by the individual in return for services rendered or goods sold in the course of carrying on his business during a particular taxation year. The CRA found that the barter dollars were eligible property for the purposes of the charitable gifts rule. The CRA based this interpretation on the definition of property in subsection 248(1) of the *Income Tax Act* (the "Act") and stated that this definition is broad enough to include the barter dollars. The definition of property in subsection 248(1) is very broad and includes a right of any kind whatsoever. The CRA was of the view that in this specific fact situation, the barter dollars constituted property within the meaning of the Act because they gave the holder the right to acquire goods. As well, as long as the units could be transferred to a third party, it was the CRA's view that they would be eligible property for the purposes of the charitable gifts rule.

The fair market value of the barter dollars would be included in the individual donor's income in the taxation year in which he made the donation. The CRA stated that subject to the application of the proposed subsection 248(35) of the Act, the registered charity could issue an official receipt for an amount equal to the fair market value of the barter dollars received, less any advantage received in respect of the gift. When proposed subsection 248(35) applies, the fair market value of a property that is the subject of a gift is deemed to be the lesser of the fair market value of the property and the cost of the property to the taxpayer. Based on the rules set out in Interpretation Bulletin IT-490 "Barter Transactions", it was the CRA's view that the cost of the barter dollars to the individual could be equal to the total value of the goods, property or services given up in order to obtain the barter dollars plus or minus any cash paid or received. We have seen CRA charities auditors take the position that barter dollars are worth considerably less than their face amount.

In the second Technical Interpretation released November 12, 2008 (Document No. 2008-0267721E5), the CRA was asked to consider whether a donation of a right to use a cottage property for a limited time was considered to be a gift-in-kind. In this situation, the CRA found that this was not a gift-in-kind for the purposes of the Act. The CRA took the position that a gratuitous loan of property is not a gift for the purposes of sections 110.1 and 118.1 of the Act since such a loan does not constitute a transfer of property, which is necessary for a valid gift to be made. This is based on Income Tax Technical News No. 17 dated April 26, 1999, which states that there is nothing to prevent a charity from paying rent or interest on a loan of property and later accepting the return of all or a portion of the payment as a gift provided that it is returned voluntarily. There must be two separate transactions which are independent of each other. In such a situation, the donor would have to report in his or her income for income tax purposes the rentor interest charged to the charity. It would also be possible for the cottage owner to lease the cottage to the charity and thereby transfer property to support receipt issuance.

CANADIAN LAW SOCIETIES INTRODUCE CLIENT IDENTIFICATION RULES

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The "Know Your Client" Rules

Canada's legal profession is governed by law societies in each of Canada's provinces and territories. Effective January 1, 2009, the law societies have enacted rules which require all lawyers to obtain basic information about the identity of clients, whether individuals or organizations. There is no discretion in the application of these rules – they must be followed by all lawyers in Canada. The rules apply to new clients and to existing clients when a lawyer is retained on a new matter.

Where the client is an organization (including most charities and non-profits), lawyers are required to obtain identification information about the organization itself and about individuals who instruct a lawyer on behalf of the client organization.

In most instances where there is a financial transaction or funds are handled through a lawyer's trust account, the rules also require verification of the identity of the client and instructing individual by inspecting and copying original identification documents.

The Rationale for the Rules

It may seem strange to clients who have dealt with a lawyer or a firm for some time to be asked to identify themselves and confirm their identity by producing documents. These are not rules imposed by Miller Thomson or any of Canada's firms or lawyers. They are rules governing all of Canada's lawyers.

There are good reasons for the rules, which have as their basis international treaty obligations entered into by Canada to combat money laundering and the financing of terrorists.

Canadian laws to address money laundering and terrorism financing received more prominence after September 11, 2001, but as early as 1989, Canada and other members of the G7 had founded an international Financial Action Task Force and agreed to international rules and protocols to address money laundering by organized crime. The UN Convention on Transnational Organized Crime also requires member states to take certain measures in their jurisdictions. The Canadian government, in accordance with obligations it has accepted under these international rules and protocols, has imposed duties (including client identification and verification requirements) upon accountants, securities dealers, realtors, casinos, dealers in precious metals and stones, banks, savings and credit unions, caisses populaires, cooperative credit societies, trust and loan companies and other financial entities that accept deposits.

In 2001 the federal government made regulations applicable to lawyers and their clients. Canada's law societies successfully challenged the regulations in court because they encroached upon constitutionally protected aspects of the solicitor-client relationship. The law societies enacted the new client identification rules which allow Canada to fulfill its international obligations while at the same time protecting the solicitor-client relationship.

Identification Information Required to be Obtained

Where the client is an individual, we are required to record the client's name, home address and telephone number, occupation and, if applicable, business address and business telephone number. Where the client is an organization, we are required to record the organization's name, business address, business telephone number and a description of the organization's business activity as well as the organization's incorporation number or business identification number and its' place of issue. In addition, we will need the individual identification details for individuals instructing lawyers on behalf of an organization. If a client retains us on behalf of a third party, we must also obtain identification information about the third party.

Verification of a Client's Identity

In most circumstances where we receive, pay or transfer funds, negotiable instruments or securities for a

client through our trust account, the rules require us to verify the client's identity. For individual clients and individuals who instruct us on behalf of organizations we must examine and retain a copy of an original identifying document such as a driver's license, a birth certificate, a health insurance card or a passport. For organizations we must examine and retain a copy of documentation which confirms the existence of the organization. We must also obtain information from the client organization about its ownership structure and the directors and controlling owners of the organization.

In many situations the rules require client identification verification information to be obtained by us before we can complete a financial transaction through the firm's trust account. We will, therefore, obtain this information from clients at the outset of our relationship or retainer on a new matter, in order to avoid any delay of vital client financial transactions.

Privacy of Identification and Verification Information

The firm has stringent measures in place to protect the confidentiality of all client information. Additional measures are in place to ensure the privacy of information provided by clients as required by the client identification and verification rules. Such information will only be disclosed to appropriate authorities as required by law.

Facilitation of the Identification Process

We will do everything possible to ensure that our compliance with the new rules does not inconvenience our clients or impede any legal transactions. If you have any questions about the new rules, please do not hesitate to contact your Miller Thomson lawyer.

WHAT'S HAPPENING AROUND MILLER THOMSON LLP?

Richard Fontaine wrote "Certains aspects Légaux des Fondations", *Revue de Planification Fiscale et Successorale* , volume 28 , no 4 (for APFF); et

Richard Fontaine wrote *Bulletin Héritage, HEC Montréal*, janvier 2009 entitled "La Planification fiscale et successorale : contribuer tout en protégeant ses héritiers"

Rachel Blumenfeld presented on "Estate Planning for Disabled Persons" at the January 14, 2009 STEP seminar in Ottawa.

Arthur Drache wrote " Political Chaos may have Silver Lining for Sector", "Encouraging the Snitches", "BCE Failed Deal, Another Blow to Charities", "CRA Releases, Registration Statistics", "Remuneration and the *Income Tax Act*", "Updated List of Foreign Qualified Donees", "Charity Commission Comments on Investment Meltdown", "Donating Use of Property Not Receiptable", "Gifts With a Condition Precedent" and "Charity Commission Okays Think Tank" in the January issue of Canadian *Not-For-Profit News*.

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