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CHARITIES & NOT-FOR-PROFIT NEWSLETTER

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Federal Budget Issue

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 2007

The March 19, 2007 Federal Budget contains a number of tax law changes that will effect parts of the charitable sector. This issue of Miller Thomson's Charities and Not-for-Profit Newsletter describes these changes and provides some of our preliminary views - future issues will provide more analysis of the changes, particularly of the new and intrusive excess business holdings regime.

FEDERAL GOVERNMENT SUPPORTS GIVING TO PRIVATE FOUNDATIONS

Susan Manwaring
Toronto
416.595.8583
smanwaring@millerthomson.com

The Federal Government delivered, in Budget 2007, the long awaited extension of the exemption from tax on gifts of publicly listed securities to private foundations. These proposals apply to gifts of such securities made on or after March 19, 2007. Similarly, the special exemption available to gifts of publicly listed securities acquired by an arm's length employee under options granted by the employer and donated to the charity within 30 days of the exercise will be extended to gifts made to a private foundation.

The federal government has been concerned for many years that private foundations can be used in all sorts of inappropriate ways. In particular, there has been a concern that private foundations can be used to hold company shares in ways that see benefits accrue to other shareholders who are related in some way to the foundation. While we acknowledge this theoretical possibility, our experience has been that abuses are exceedingly rare and can likely already be dealt with under existing law.

Nevertheless, with the extension of these incentives, the Budget proposes rules designed to prevent these potential abuses. To address these self-dealing concerns, the Government has borrowed a concept from the United States and is proposing to introduce an excess business holdings regime applicable only to private foundations. These proposals will apply to all private foundations beginning with their first taxation year that begins on or after March 19, 2007. The regime will apply to holdings of both publicly listed *and unlisted shares of private companies*. In other words, it has extremely broad application and will impact private foundations across Canada in ways we expect the Department of Finance has not understood. This is unfortunate.

The new rules identify three ranges of shareholdings and apply different rules to each range.

Safe Harbour

Where a private foundation holds 2% or less of all outstanding shares of each class of a corporation, the foundation will be in a "safe harbour". If the foundation is in this range, it will not be required to monitor, report or divest itself of any shares.

Monitoring Phase

Where a private foundation, at any time in a taxation year, holds in excess of 2% of the outstanding shares of one or more share classes of a corporation, it will be required to determine and report to the Canada Revenue Agency (CRA), the shares held at the end of the year in all share classes of that corporation, by it and by any person not dealing at arm's length with the foundation.

The foundation will also be required to report any material transactions of the foundation or the non-arm's length person(s) which took place at a time when the shareholdings were in excess of the safe harbour limit during the year. A transaction will be material if it involves the acquisition or disposition of more than $100,000 worth of shares of a particular class or more than 0.5% of the outstanding shares of a particular class.

This reporting will presumably be on the T3010 Information Return and will be available to the general public on the CRA Charities Directorate website except that the names of the non-arm's length persons will only be disclosed to CRA: they will not listed on the CRA website.

Divestment Required

Where the private foundation and all non-arm's length persons together hold more than 20% percent of all outstanding shares of any share class of a corporation, the rules will require the foundation or the non-arm's length persons (or a combination of the two) to divest themselves of the shares so the combined holdings are 20% or less. Penalties will apply to the foundation where the foundation and the non-arm's length persons have not reduced their combined shareholdings of that class to 20 percent within specified time periods.

The same reporting requirements and thus public disclosure apply to the foundation at this stage as well.

Non-arm's length

Non-arm's length persons for these purposes will include any person, or member of a related group of persons, that controls the foundation, and any person not dealing at arm's length with such a controlling person or controlling group members. Special rules will apply to deem persons not to be related to a controlling person or member of a control group. These rules will require an application to the Minister for a determination that the person is dealing at arm's length and will be available where a person is 18 years of age and living separate and apart from the controlling person or member of the control group. It will be a fact based determination and we expect the onus will be on the individual or the foundation to prove the arm's length status.

Timing for Divestiture

Where a divestiture is required, the length of time in which the foundation or the non-arm's length person must divest will depend on how the excess business holdings arose. For example, if the foundation had purchased the shares, the divesture must be completed by the end of the year while if the excess is the result of a bequest, the excess must be divested by the end of the 5th subsequent year. The theme is if the shares were purchased by the foundation or a non-arm's length person, the divestiture must be completed sooner than if the excess is the result of a gift. CRA will also have discretion to specify conditions and defer divestiture upon application.

These timing proposals were, we expect, the result of concerns raised in earlier consultations about the negative consequences of inflexible divestiture rules.

Penalties

The penalty for failing to comply with the divestiture requirements is like the other intermediate sanctions introduced in 2004. The penalty will apply to the private foundation. The initial penalty will equal 5% of the value of the excess holdings at the end of the relevant period. If there is a second offence within 5 years, the penalty will be 10%.

Further, where the foundation has been found to have an excess holding and the foundation has failed to provide the required information relevant to excess holdings, the excess business holdings penalty will be doubled.

Transitional Rules

These proposals contain substantive transition provisions which will allow foundations to divest, over a period of 5 to 20 years excess business holdings present on March 18, 2007. This is designed to assist those private foundations in existence that have been operating under the current legislative regime and that may very well be offside the new rules. Subject to detail, the transitional rules generally require that the excess holdings be reduced by 20% every 5 years until they are eliminated. Finance officials have indicated previously that in discussions with the IRS about these rules, this timeline was considered to be sufficient.

The government proposes to deny to donors to those Foundations who are not able to eliminate the excess business holdings before March 18, 2012, the exemption from tax on the capital gain realized on gifts of publicly listed securities. It is extremely difficult to understand the need for this penalty. To give with one hand and take away with the other seems unreasonable. It is not obvious why, if the transition rules are appropriate, the government felt the need to add this penalty to those that need to take additional time. Hopefully this aspect of the proposals will be eliminated as we move forward.

Conclusion

While the extension of the capital gains exemption to gifts of public securities to private foundations is desirable, the accompanying excess business holdings rules are unnecessarily complex and broad in scope. They will serve to penalize existing private foundations that have implemented structures properly and in accordance with the current provisions of the *Income Tax Act*. There is no doubt that founders of private foundations across the country asked for the extension of the exemption from tax on capital gains realized from gifts to their foundations. The intent behind that act was philanthropic. For the government to have used this as an opportunity to propose such a far reaching and complex rule which completely changes the regulatory regime for existing private foundations is disappointing.

Private foundations holding any significant amount of any public or private securities will need to monitor the shareholdings of both the foundation and of non-arm's length persons - this will create a significant compliance headache for foundations and their advisors. Private foundations in either of these situations should seek legal advice immediately.

DONATION OF MEDICINES FOR THE DEVELOPING WORLD

Robert Hayhoe
Toronto
416.595.8174
rhayhoe@millerthomson.com

The need for medicine in the developing world is often very urgent. When a Canadian corporation, like a pharmaceutical company, donates its inventory to a registered charity, it receives a tax deduction equal to the fair market value of the property donated, but is also subject to an income inclusion in the same amount. As a result, there is no tax benefit to the corporation for making the gift - the corporation is tax indifferent between burning the inventory and donating it to charity.

The budget proposes to provide an incentive for corporations that donate medicines from inventory by providing an additional tax deduction equal to the lesser of:

- 50% of the excess of fair market value over cost, and
- the cost of the donated medicine,

upon a donation to a registered charity that receives Canadian International Development Agency funding.

This change, effective for gifts made after March 19, may well encourage gifts of pharmaceuticals to development charities. However, a number of legal issues will need to be addressed. Will the CRA provide any guidance on the valuation of pharmaceuticals? How is cost to be calculated (an issue that already vexes tax authorities in the transfer pricing context)? Will tax shelter promoters seek to use this change to validate existing and new donation shelters involving pharmaceutical donations?

We will monitor these changes and their implementation, in order to continue to advise our international relief and development and other charity clients.

BUDGET 2007: ASSISTING PEOPLE WITH DISABILITIES

Rachel Blumenfeld
Toronto
416.596.2105
rblumenfeld@millerthomson.com

The March 19, 2007, Federal Budget, includes a number of measures to assist persons with disabilities and their families. In particular, the Budget proposes to introduce a "Registered Disability Savings Plan" (RDSP) to allow disabled individuals, their parents or other "legal representatives" to accumulate savings on a tax-deferred basis for disabled individuals.

The RDSP is intended to work like the Registered Education Savings Plan that parents and others are entitled to establish to save for a child's post-secondary education. "Canada Disability Savings Grants" will be available whereby the government will match RDSP contributions. The matching rate will depend on net family income and the amount contributed, and may be as high as 300% of the RDSP contribution. Further, the Budget proposes to assist lower income families with disabled children by paying "Canada Disability Savings Bonds" to RDSPs even where the family has not made a contribution. CDSBs of $1000 a year will be paid to families with income not exceeding $20,833 (indexed in subsequent years); the value of the CDSB will be reduced gradually as the family net income increases (to a maximum of $37,178). A lifetime limit of $20,000 may be paid in respect of an RDSP beneficiary.

As with an RESP, it is proposed that contributions to an RDSP will not be deductible, but the income that accrues on contributions will not be taxable while held in the RDSP. When funds are paid out of the RDSP to the disabled beneficiary, the investment income, the CDSG and CDSB will be taxable to the beneficiary (presumably at a relatively low tax rate).

RDSP payments must commence by the end of the year in which the disabled person turns 60 and will be limited to a maximum amount based on the value of the assets in the plan and the individual's life expectancy. Unlike with an RESP, contributors to an RDSP for a disabled beneficiary will not be entitled to a refund of contributions. Rather, on the death of the beneficiary or cessation of his or her disability, the funds (net of re-payment of the CDSG and CDSB) will be paid to the beneficiary or his or her estate.

The Budget documents indicate that the federal government will work with the provinces to ensure that RDSPs are "an effective savings vehicle to improve the financial security and well-being of children with severe disabilities." To this end, it is hoped that value of the RDSP does not disqualify a disabled beneficiary from receiving provincial disability benefits (like the ODSP in Ontario) when examining the disabled person's assets. The federal government has indicated that the income from RDSPs will not be taken into account when determining eligibility for income-tested federal benefits, including Old Age Security and Employment Insurance; hopefully the provinces will ensure that payments from RDSPs will supplement provincial benefits rather than allow the provinces to reduce the already-low level of benefits provided to disabled persons.

In addition to the RDSP regime, the 2007 Budget introduces a supplement to the new "Working Income Tax Benefit" for persons with disabilities. The purpose of this benefit is to assist disabled persons with the special expenses they often incur for disability supports when pursuing employment opportunities.

Charities that serve persons with disabilities will need to understand these new rules in order to best protect those they serve. Miller Thomson's private client services lawyers are expert at assisting persons with disabilities and their families with the goal of maximising the income and assets and lifestyle of disabled persons.

OTHER ITEMS OF NOTE FOR THE CHARITABLE SECTOR

Kate Campbell
Toronto
416.595.8197
kcampbell@millerthomson.com

The 2007 Federal Budget contained further proposals that will impact the charitable sector.

Loanback Rules

Current rules provide that where property is gifted to a charity and loaned back to or made available for use by the donor or a person not at arm's length from the donor, the value of the gift will be reduced. While this provision had only applied to donors who were not at arm's length from the charity, the Federal Budget proposed to extend this rule to all donors for gifts made on or after March 19, 2007.

Trusts with a Private Foundation Beneficiary

Where a donor affiliated with a trust makes a gift of non-qualifying securities (such as shares of a private corporation which the donor controls) to the trust and a private foundation is the beneficiary of the trust, it is proposed that the donor will not receive a charitable credit or deduction until the shares are sold. This rule will apply on gifts made on or after March 19, 2007. A similar rule currently applies to donations of non-qualifying shares made directly to a private foundation.

Elementary and Secondary School Scholarships

For 2007 and subsequent taxation years, the total amount of scholarships and bursaries received by an individual to attend elementary or secondary school will be excluded from the individual's income and therefore will not be taxed.

Prescribed Stock Exchanges

The capital gains exemption applies to donations of shares listed on a "prescribed stock exchange" as set out in the Regulations to the *Income Tax Act*. The budget proposes to change this requirement to stock exchanges designated by the Minister of Finance. Such designation will be made by public notice listed on the Department of Finance website. It is expected that the all of the prescribed exchanges will be designated. This new procedure has the potential to be more responsive as the list should be easier to update.

GST

For fiscal years after 2007, the threshold for a charity to elect an annual GST reporting period increased from taxable supplies not exceeding $500,000 to those not exceeding $1,500,000 annually.

ARTICLES

NEW CRA POLICY ON ASSOCIATED CHARITIES

Arthur Drache
Toronto
416.595.8681
adrache@millerthomson.com

The concept of associated charities has been part of the *Income Tax Act* from the time the rules on charities were enacted for the first time in the 1970s.

The general rule for charitable organizations (as opposed to charitable foundations) is that they cannot distribute more than 50% of their annual income to other charities. This limitation was consistent with the notion that charitable organizations were supposed to carry on their works themselves, not to fund other charities. Before the enactment of this rule, there was a body of thought that a charity could not (unless its objects specifically allowed for it) transfer funds to another charity.

But the 50% limitation became a problem for organizations which were national in scope and had multiple registered branches, often at the provincial level. For example, the central organization might be directly

involved in research which the provincial organizations did minimal direct charitable work but raised the lion's share of the money. The notion of "association" was based on the concept that a group of organizations (think individual churches of a religious group) had, in the view of the Minister of Revenue substantially the same aim or activity.

Association status would allow a free flow of funds between all the associated charities without the 50% limitation being applied.

In a new policy statement, CPC-028, the CRA has substantially broadened the notion administratively. In effect, it will allow for association based on two organizations working together on a single project regardless of what their overall fundamental objects are.

The guidelines are fairly clear and simple and we reproduce the "rules" in their entirety:

1. A registered charity can be designated as associated with one or more specified registered charities to undertake a joint project (e.g., construction of an art centre).
2. Two or more registered charities that are normally unrelated may form a relationship by agreement to undertake a joint project. In this case the CRA must receive complete details on how the project will operate, how each of the registered charities will participate to achieve the common goal and the duration of project.
3. The designation as associated charities will be in effect for the duration of the joint venture.
4. If the joint project is not completed within the time frame specified, the charities can request an extension to their associated status.
5. If the joint project is completed prior to the expiration of the associated status, the charities should request revocation of their associated status.

We assume that this policy statement is in reaction to some concerns which were voiced by registered organizations that found impediments to working together where one might be the primary funder of a project and where the statutory limitations were too narrow. The new policy is administratively progressive and, provided the CRA is not overly harsh on applicant organizations under point 2 above, the policy should be welcomed.

A GOOD CAUSE WITH A MORAL DILEMMA

Damir Karaturovic
Kitchener-Waterloo
519.593.3240
dkaraturovic@millerthomson.com

Managing the marketing material of any organization can be a cumbersome process. This issue can become even more problematic for large organizations that deal with many third party contractors supplying different aspects of their marketing materials, especially when trying to deal with issues related to copyright.

Copyright can exist in any type of creative work, whether it is a picture on a webpage, the written material in a brochure or the music played over the radio. An organization, including a charity, may employ graphic design artists or writers themselves, but typically outside independent contractors are engaged to create the creative works.

The *Copyright Act* governs all of the issues related to copyright in Canada and the *Copyright Act* gives certain, specific rights that will always be with the author. These are known as "moral rights."

An author, for copyright purposes, will always be the person who actually wrote the article or drew the drawing or took the picture. Even if these authors were paid for the work and the charity owns the work, moral rights always remain with the author. A company or charity is almost never the author of a work, since an individual will always be involved in the actual creative process. And this is an important distinction.

A "moral right" is defined in the *Copyright Act*, and means that an author has the right to the integrity of the

work. In order for the integrity of the work to be infringed, what must be shown is that the work:

- has been distorted, mutilated or otherwise modified, OR
- is used in association with a product, service, cause or institution which is to the prejudice of the honour or reputation of the author.

Of particular importance to a charity is where a work is used in association with a product, service, **cause** or **institution** which is to the prejudice of the honour or reputation of the author.

When looking at the causes that a charity might support, an author of a work may become confused with respect to which cause the work might become associated. Charities today often do work for many causes. Whether it is raising money for local homeless shelters or delivering aid to Africa, there are charities that may find that their scope is global in nature and that the causes that they support can be quite varied.

So, if an author has created a particular work believing it will only be used for a local foodbank and later found that the same work is being used to promote contraception techniques to protect against AIDS in Africa, the "cause" to which the author had given his work could conceivably have changed.

There is some debate as to whether the prejudice that affects the author's honour or reputation must be determined in an objective standard only looking at the person as an author, or whether a personal element associated with the author is also relevant. As such, an author's personal reputation, and not just their reputation as an artist, would likely be relevant to any such proceeding. If the author in the scenario mentioned above was personally opposed to the use of certain types of contraception, it is possible that the author could receive a court order that all of the marketing materials associated with the AIDS in Africa campaign stop being aired or distributed, and possibly even destroyed.

So how can one ensure that an author's moral right in a work will not affect the charity that is presently using it?

Since a moral right is a personal right of the author, it cannot be licensed or sold. Therefore, only the author can ever have the moral right. But while an author cannot give the author's moral right away, the author can waive his moral rights when selling or licensing the work. What this means is that the author is willing to give up his ability to bring forward a moral rights infringement case at some point in the future.

However, the wording of any such waiver must be reviewed carefully. Unless there is an express term in the waiver of the author's moral rights, the person who has been given the waiver can sell or license the works to others and the waiver will flow through the works. Therefore, when your organization is licensing a work from someone who is not the author, it is incumbent upon the organization to ensure that the third party be able to produce a properly executed waiver of the moral rights from the author.

Additionally, the author may agree to waive his moral rights for all but certain types of acts or causes. Only by ensuring that every author of a copyrighted work, including a charity's own employees, has waived their moral rights can a charity ensure that it won't be caught by someone else's moral dilemma.

WHAT'S HAPPENING AROUND MILLER THOMSON LLP

John Phillips spoke on Planned Giving at a seminar sponsored by Mackenzie Financial and Edward Jones at the Glencoe Club in Calgary on February 28.

The *Canadian Fundraiser* contained "FLOW THROUGH SHARES- Attractive option for taxpayers, but charities should be cautious" by **Susan Manwaring** in February.

The March *Canadian Not-For-Profit News* included "Charitable Goods Policy", "Federal Panel Reports on Grant Delivery", "Elimination of Tax Barriers Spurs Magnificent Gifts", "Heritage Committee Vindicates Court Challenges Programme" and "Shareholders Agreements for Private Foundations" by **Arthur Drache** and "Exemption for Audit Requirements Expanded" by **Hugh Kelly**.

Arthur Drache spoke on "Private Foundations" and **Robert Hayhoe** spoke on "Gifts to Avoid" at a February seminar organised by the Toronto Chapter of the Society of Trusts and Estates Planners.

Rachel Blumenfeld was a faculty member for an Osgoode Professional Development Course on Estate Planning and Estate Administration held in February.

Martin Rochwerg was quoted in a February article on charitable remainder trusts published by the Baycrest Foundation.

MILLER THOMSON LLP CHARITIES & NOT-FOR-PROFIT GROUP

Toronto/Markham

Rachel L. Blumenfeld	416.596.2105
Kate Campbell	416.595.8197
Arthur B.C. Drache, Q.C., C.M.	416.595.8681
Mark R. Frederick	416.595.8175
Kathryn M. Frelick	416.595.2979
Robert J. Fuller, Q.C.	416.595.8514
Robert B. Hayhoe	416.595.8174
Hugh M. Kelly, Q.C.	416.595.8176
Michael Kerr	416.595.8620
Jacqueline L. King	416.595.2966
Peter D. Lauwers	905.415.6470
Susan M. Manwaring	416.595.8583
Rosanne T. Rocchi	416.595.8532
Martin J. Rochwerg	416.596.2116
Amanda Stacey	416.595.8169
Brenda Taylor (Corp. Services)	905.415.6739
Michael J. Wren	416.595.8184

Vancouver

Kenneth Burnett	604.643.1203
Sandra L. Enticknap	604.643.1292
Martin N. Gifford	604.643.1264
Alan A. Hobkirk	604.643.1218
Eve C. Munro	604.643.1262
Monique P. Trépanier	604.643.1274

Calgary

Esmail Bharwani	403.298.2418
William J. Fowlis	403.298.2413
John D. Phillips, Q.C	403.298.2431
Gregory P. Shannon	403.298.2482
Bryant Frydberg	403.298.2456

Edmonton

Bruce N. Geiger	780.429.9774
Dragana Sanchez Glowicki	780.429.9703

London

Kristina Shaw	519.931.3511

Kitchener-Waterloo

Stephen R. Cameron	519.593.3207
John J. Griggs	519.593.3231
J. Jamieson K. Martin	519.593.3247
Richard G. Meunier, Q.C.	519.593.3251

Guelph

Frank O. Brewster	519.780.4618
Lorelei Graham	519.780.4650
Robin-Lee A. Norris	519.780.4638

Montréal

Ronald Auclair	514.871.5477
Richard Fontaine	514.871.5496
Marie-Michele Lavigne	514.871.5490
Louise Tremblay	514.871.5476

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