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CHARITIES AND NOT-FOR-PROFIT NEWSLETTER

The Charities and Not-for-Profit Newsletter is published monthly by Miller Thomson LLP's Charities and 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.

Inside

SUPPORTING FOREIGN UNIVERSITIES

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Foreign universities and schools that want to provide official tax receipts to support the efforts of their Canadian donors have a few options.

Prescribed Foreign University

The *Income Tax Act* (Canada) allows donors to claim charitable credits or deductions for gifts to a university outside Canada that ordinarily includes students from Canada in its student body. The universities that qualify are listed in Schedule VIII of the *Income Tax Act Regulations*.

Donors can make direct gifts to a prescribed university. Students may also claim tuition, education and textbook tax credits on their Canadian income tax return for attending these institutions.

The Canada Revenue Agency (CRA) reviews applications for prescribed status and takes the administrative position that in order to qualify for prescribed status a university must meet the following conditions:

- it maintains an academic entrance requirement of at least secondary school matriculation standing;
- it is organized for teaching, study and research in the higher branches of learning;
- it is empowered, in its own right, to confer degrees of at least the baccalaureate level (Bachelor or equivalent), according to academic standards and statutory definitions prevailing in the country in which the university is situated; and
- it ordinarily includes Canadian students in the institution's student body.

CRA requests student data for the last ten years and has stated in a technical interpretation from 2008 that these students can include Canadian residents enrolled in distance learning programs.

CRA informed us recently that it plans to interpret this section more restrictively and will be reviewing those currently on the list. We recently had a case where the CRA turned down a university which had a long history of Canadian students in its student body because the university only received the right to grant degrees in the last few years (rather than having its students receive degrees thorough an affiliated institution). The CRA claimed that the university had to be able to grant degrees on its own for the last ten years. We believe this position is wrong and would not be upheld by the courts. Our Charities and Not-For-Profit lawyers can help universities challenge CRA on these decisions.

Canadian Friends Charity

Universities and schools that do not qualify for prescribed status can create a Canadian charity to support the foreign school. This option requires the creation of a independent Canadian charity.

Canadian law prevents the Canadian registered charity from simply granting money to the foreign university. Instead the Canadian charity must carry on its own activities. Typically, the Canadian charity carries on its own scholarship program, pays for teachers' salaries, or buys books for the school's library. This option requires directors or trustees to run the Canadian charity and be in control of its activities. The charity and the school will need written agreements regarding any activities the school carries out under the direction of the Canadian charity and the school must provide reports to the Canadian charity regarding these activities.

Miller Thomson LLP's Charity and Not-For-Profit lawyers can assist foreign schools to review and implement these options.

NEW SECURITIES RULES ENHANCE PROTECTION FOR CLIENTS OF PROFESSIONAL MONEY MANAGERS

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The management of endowments or capital pools of any significant size is most often entrusted to a professional money manager. Recent changes to securities regulation have been made with the stated intent of better protecting investors, including institutional investors such as charities. The changes affect the way that money managers conduct business. In particular, under the new regulatory regime, money managers of all stripes and colours will be required to maintain stringent standards of business conduct and have in place appropriate risk management policies and procedures. The new rules enhance certain disclosures which money managers are required to make to clients about the nature of the manager-client relationship. Organizations which have appointed money managers should take this as an opportunity to review existing account documentation to ensure it is complete and that additional information which money managers are now mandated to supply has been or will be properly furnished.

Background

Professional money managers are generally subject to the supervision of securities regulatory authorities. Canada enjoys the dubious distinction of being the only developed country without a national or federal securities regulator. Securities regulation is a provincial responsibility, meaning that technically speaking, we have thirteen separate securities regulators (the ten provinces and three territories). In practice, to make the system workable, the regulators co-operate where possible to have rules which are consistently applied across the country. This requires sustained effort, continual monitoring and the expenditure of a great deal of time. (Readers should note that the Government of Canada has an initiative underway for a national securities regulator and it has established the Canadian Securities Transition Office to put together a plan whereby provinces will be able, but not obligated, to "opt in" to a Canadian Securities Regulator. See www.csto.ca)

A recent and significant example of coordination and cooperation on the part of securities regulators is the release and implementation of National Instrument 31-103 (NI 31-103), *Registration Requirements and Exemptions*. In securities regulatory terms, professional money managers, when they manage client money on a discretionary basis, are engaging in the activity of "advising". Like other regulated professions, the business of advising with respect to investments can only be carried on by persons properly registered to do so. This registration requirement is the primary regulatory means by which the consumers of these services can be assured of some degree of protection from incompetence, negligence or fraud. Since "advising" can encompass such a wide range of activities, the rules provide for certain exceptions to the registration requirement in appropriate circumstances.

As far as money managers are concerned, NI 31-103 provides for a more consistent, harmonized and efficient registration regime that applies in all Canadian jurisdictions. To take one example, prior to NI 31-103, a money management firm with offices in Ontario, Quebec and British Columbia would have to register separately in each of those provinces. There were often minor, and idiosyncratic, local variations so that for example, the individual portfolio managers employed by the firm would be registered in different "registration categories"

depending on the jurisdiction. More significantly, the various exemptions from the registration requirements could also vary by province. NI 31-103 largely addresses and eliminates these discrepancies.

Enhanced Investor Protection Measures

Importantly for the clients of money managers, the new national registration regime contains enhanced investor protection measures. Chief among the new rules are those relating to the maintenance of an effective compliance and control regime by every registered money manager. Investment advisory firms must designate a senior officer as its Chief Compliance Officer or CCO. The CCO is to be responsible for the overall design and effectiveness of the firm's compliance system. The compliance system overseen by the CCO must have policies and procedures that provide reasonable assurance that the firm and its professionals act in compliance with applicable securities legislation. The firm's documented set of internal controls must be designed to detect incidents of non-compliance and address any breaches in a timely and appropriate fashion.

Supporting this are provisions relating to financial reporting to authorities, prescribing the amount of regulatory working capital that firms are to maintain, mandating the type and amount of insurance a firm must have, and setting out the minimum professional qualifications for the individual portfolio managers.

There are also new rules on how client complaints must be handled by money management firms, and a mandatory requirement for dispute resolution. A firm is required to respond to complaints "in a manner that a reasonable investor would consider fair and effective". If a complaint is not resolved to the satisfaction of the client, the firm must make available, at its expense, a dispute resolution or mediation service. These rules will be phased in and become operational over the next two years.

Finally NI 31-103 reinforces the view that disclosure, particularly of fee arrangements and of any conflicts of interest, is key to investor protection. To that end, every firm must provide a package of information, called the "relationship disclosure information", which describes for the client:

- the nature of the client's account with the firm
- the products and services offered by the firm
- the risks that the client should consider, including risks associated with borrowing to invest
- the conflicts of interest applicable to the firm
- the costs to the client in operating the account
- the basis of the compensation paid to firm
- the content and frequency of the firm's reports to the client, and
- certain other information about the client's rights (for example the right to the dispute resolution service) .

These rules also are being phased in and will be fully effective by September 28, 2010.

Action Items

If an organization has retained the services of one or more professional money managers, now would be a good time to review the legal documentation pertaining to that relationship. This would generally consist in most cases of a legal agreement known as the investment management agreement, or IMA. In addition, there will be various pieces of account opening documentation, including suitability and “know your client” forms. In view of NI 31-103, certain amendments to this documentation may be in order.

Although the money manager is a fiduciary for legal purposes, the client nevertheless has a responsibility to be informed as to their rights and remedies. So clients should be inquiring about those items listed above as constituting the relationship disclosure information. They should inquire about fee arrangements, about transaction costs in addition to fees, and about possible conflicts of interest and how the firm addresses the conflicts. Clients should ensure that they understand the responses and ask for additional explanation or clarification where required. They should engage in a frank discussion with the investment management firm on risk management policies and procedures. If the past two years have taught us anything, it is that the sheer size of a financial services company is no guarantee against recklessness or the taking on of inappropriate and poorly understood risk.

NI 31-103 marks a significant milestone in the regulation of money managers. Organizations will be well advised to make sure that they are positioned to take full advantage of the benefits and protections afforded clients through these new rules.

DONATION OF EXCHANGEABLE SHARES

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Prospective donors and registered charities should take note of a recent Canada Revenue Agency ("CRA") Advance Income Tax Ruling on the donation of exchangeable shares.

CRA recently considered whether the fact pattern and transaction described herein enables a donor to gift exchangeable shares without any capital gains tax on the disposition of exchangeable shares. The facts on which CRA provided its ruling are as follows:

- Taxpayers hold exchangeable shares in Corporation A;
- Corporation A is controlled by Corporation B. The ordinary shares of Corporation B are listed for trading on a designated stock exchange;
- Each of the taxpayers owns non-voting exchangeable shares in the share capital of Corporation A (the "Exchangeable Shares"). The particulars of the Exchangeable Shares are as follows:
    - Each Exchangeable Share is equivalent to one Corporation B share and includes a right to exchange the share for a Corporation B share;
    - Holders of Exchangeable Shares are entitled to give notice of an intention to exercise a right to exchange their Exchangeable Shares (the "Notice") for Corporation B shares (the "Consideration");
    - Upon receipt of a Notice, Corporation B or a subsidiary of Corporation B (other than Corporation A) has an overriding right to purchase the Exchangeable Shares for the Consideration ("Call Right);
    - If Corporation B or a subsidiary of Corporation B (other than Corporation A) fails to exercise its overriding right described above, the holder of the Exchangeable Shares must redeem their Exchangeable Shares for the Consideration.

Based on the above facts, the taxpayers purport to undertake the following transaction:

- Each of the holders of the Exchangeable Shares delivers a Notice to Corporation A for all of their Exchangeable Shares;
- Corporation B or a subsidiary (other than Corporation A) will exercise its Call Right, or the holder of the Exchangeable Shares will redeem their Exchangeable Shares for an equivalent number of Corporation B shares;
- The only consideration received by the holder of the Exchangeable Shares is shares in Corporation B;
- Within 30 days of the exchange, the former holders of the Exchangeable Shares will gift the recently received Corporation B shares (the "Donated Shares") to a qualified donee and there is no advantage in respect of the gift.

CRA ruled that to the extent that the taxpayer has a capital gain arising from the disposition of the Exchangeable Shares, the capital gain will be deemed to be zero if the following elements are met:

(a) At the time of the exchange, the Corporation B shares are listed on a designated stock exchange;

(b) The only consideration received on the exchange is Corporation B Shares;

(c) The Exchangeable Shares are capital property (as defined in the *Income Tax Act*) of the taxpayer;

(d) The taxpayer gifts the Corporation B shares to a qualified donee within 30 days of the exchange;

(e) The recipient of the gift is a qualified donee at the time the gift is made; and

(f) The amount of the advantage is nil.

This ruling confirms CRA's position with respect to the capital gains treatment on the disposition of exchangeable shares and donors holding exchangeable shares should keep this ruling in mind when considering their philanthropic activities.

RESIDENCY OF A CHARITABLE TRUST

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Traditionally, courts have held that a trust is resident where the majority of its trustees are resident. However, the *Garron Family Trust v. Her Majesty the Queen, 2009 D.T.C. 1287 (T.C.C.)* decision shows that this rule will not always prevail.

On September 10, 2009, the Tax Court of Canada released its decision in *Garron* and several other cases heard on common evidence. The court held that two Barbados Trusts were resident in Canada for purposes of the Agreement between Canada and Barbados for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital (the "Canada-Barbados Treaty"). Over $450 million in capital gains were realized by the two Trusts on the disposition of shares of Canadian corporations. Under Barbados domestic law, the gains were not subject to tax. The Trusts claimed they were exempt from Canadian tax under the Treaty. The Minister disagreed and assessed accordingly. The Trusts appealed. The Tax Court of Canada dismissed their appeals. This case is now under further appeal.

New Test for Residence of Trusts – Central Management and Control

Justice Woods, in this case, rejected that the oft-cited Federal Court decision in *Thibodeau* stands for the proposition that the residence of the trustee is always the deciding factor in determining the residence of a trust. In *Garron*, the court adopted a central management and control test for the residency of trusts. Justice Woods concluded that the "judge-made test of residence that has been established for corporations should also apply to trusts, with such modifications as are appropriate. That test is 'where the central management and control actually abides'."

Factors in Determining Central Management and Control

In finding that the central management and control of the Trusts was located in Canada with the two Canadian principals, either directly or indirectly through their advisers, rather than with the Barbados resident Trustee, the court took a number of factors into account. Some of these factors included that:

1. The "protector" of the Trusts could replace the Barbados Trustee, and the Canadian principals, with their spouses, could replace the "protector";
2. The internal memoranda of the Trustee evidenced a role actually more limited than the trust documents suggested;
3. Investment decisions appeared to be at the direction of the Canadian principals with Canadian investment advisers;
4. There was virtually no documentation showing that the Barbados Trustee took an active role in managing the Trusts;
5. The documentary evidence was consistent with the Barbados Trustee being involved for the most part only in the execution of agreements, and in administrative, accounting and tax matters;
6. At the relevant time, the Barbados Trustee was the arm of an accounting firm which provided

significant tax advice regarding the overall offshore structure of the property held by the Trusts. It was questionable whether the Barbados Trustee had expertise in managing trust assets as opposed to the firm's significant expertise in accounting and tax matters;

7. There was no evidence that the Canadian principals were very interested in what the Barbados Trustee was doing and that the persons involved were competent, as would have been the case if the Barbados Trustee was actively involved in the sale of the shares at issue;
8. The contact for the bank, the Bahamas branch which was used for the bank account of one of the Trusts, was made in Toronto;
9. The directors of the Barbados Trustee had very little information regarding transactions to be approved before the directors ratified the transactions; and
10. One of the Canadian principals oversaw the sale of the shares.

The court indicated that it could not be assumed that the Barbados Trustee did whatever was required to make sure the transactions undertaken by the Trusts were in the best interests of the beneficiaries. On this point, the court found that there was no evidence that the operator of the Barbados Trustee had expertise or significant experience in trust management nor was it a well-recognized trust corporation with significant experience and expertise in managing trusts.

Implications for Charitable Trusts

The analysis by the court in Garron on determining the residency of a trust may be relevant to trusts established for charitable purposes. One of the requirements which a charitable purposes trust must meet to be a "registered charity" for Canadian tax purposes is that it be "resident in Canada". Where the central management and control of a charitable trust, which has received "registered charity" status or which is seeking "registered charity" status, might be considered to be outside of Canada, notwithstanding that all or the majority of its trustees are resident in Canada, the trustees may wish to get legal advice regarding this issue.

If you would like to know more about this case or its implications, please contact the lawyers in Miller Thomson LLP's Charities and Not-For-Profit Group.

SCOPE OF THE UNITED NATIONS INCOME DEDUCTION: *JAMES NIGHTINGALE V. HMTQ* 2010 D.T.C. 1043

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During 2004 and 2005, James Nightingale worked for the Vietnam Veterans of America Foundation ("VVAF") in Iraq as a Technical Advisor for the foundation's Information Management and Mine Action Program ("IMMAP"). IMMAP was funded, in part, by the United Nations (the "UN"). Although his work with the VVAF involved projects with the UN and coordination with UN personnel, Mr. Nightingale was paid directly by the VVAF. Both before and after working with the VVAF, Mr. Nightingale was employed by the UN.

Mr. Nightingale, a resident and citizen of Canada, deducted the amounts he received from the VVAF in computing his taxable income for 2004 and 2005, by relying on a provision of the *Income Tax Act* (Canada) (the "Act") that effectively exempts employment income received from the UN or a specialized agency of the UN (the "UN Income Deduction").

Mr. Nightingale's 2004 and 2005 income tax returns were reassessed and his claims for the UN Income Deduction were denied because the VVAF is not considered a specialized agency of the UN for the purposes of the Act. Mr. Nightingale appealed the reassessments to the Tax Court of Canada.

On appeal, Mr. Nightingale argued his employment with the VVAF in Iraq was indirectly with the UN and, therefore, he qualified for the UN Income Deduction. He also raised arguments, based on the *Canadian Charter of Rights and Freedoms* (the "Charter"), alleging discrimination under the Act with respect to citizens

of Canada, as opposed to citizens of the United States, who are Canadian residents for tax purposes and Canadian civilians working on risky missions around the world, as compared to Canadian military or police personnel whose income received in the course of the same or similar deployments is deductible in computing taxable income.

In dismissing his appeal, the Court rejected all of Mr. Nightingale's arguments and found that he neither qualified for the UN Income Deduction nor suffered discrimination in a manner that invoked the Charter. A summary of the Court's decision is provided below.

The UN Income Deduction Argument

This argument turned on whether Mr. Nightingale was employed by the UN, since the VVAF is not a specialized agency of the UN for Canadian tax purposes. Citing that there was no contractual relationship between Mr. Nightingale and the UN and that there was no evidence of any direct control of Mr. Nightingale's activities by the UN, the Court confirmed that the UN Income Deduction was unavailable to Mr. Nightingale during the relevant period.

Charter Argument based on Citizenship

Mr. Nightingale contended discrimination under the Charter based on the application of certain Articles of the *Canada-United States Income Tax Convention* (*1980*) (the "Convention") that address issues arising where the citizenship and residence of a taxpayer may be different. The Court could not reconcile the interpretations proffered by Mr. Nightingale with either the facts at hand or the language of the Convention itself and could not discern discrimination based on citizenship in either case.

Charter Argument based on Occupation

Although employment income for Canadian military and police personnel serving in high-risk locations is effectively exempt from income tax, the Act does not provide an exemption for employment income received by a Canadian civilian employed in comparable circumstances. While characterized by the Court as discrimination based on occupation status, this difference in treatment was not considered to fall within the scope of discrimination contemplated by the Charter. Thus, in this regard, the Charter was of no consequence to Mr. Nightingale.

WHAT'S HAPPENING AROUND MILLER THOMSON LLP

Arthur Drache wrote "Budget Promises Don't Necessarily Produce Changes", "Federal Shuffle Brings Little New Blood", "Parliamentary Arts Caucus Created", "Matching Grant Programme For Haiti Aid", "Foreign Membership Fees and Similar Payments", "Donation of Flow-Through Shares to Charities", "Revocation Tax Liability Clarification" and "Fundraising Postal Stamp Issued by Canada Post" in the February 2010 issue of *Canadian Not-For-Profit News*.

Hugh Kelly led a workshop for Ontario Catholic School Trustees Association on the impact of Bill 177 on school board governance on Friday, January 15, 2010.

Hugh Kelly presented jointly with Susan LaRosa, Director of Education, York Catholic District School Board, on the Roles of the Board, the Trustees and the Director to Candidates for School Board Trustee on January 23, 2010.

Roxanne Chow's article "Charities, Donation Request & Anti-Spam: The Effects of Bill C-27" was reprinted in the February 2010 issue of *Canadian Not-For-Profit News*.

Robert Hayhoe presented a Webinar on CRA Charity Audits on February 18, 2010.

Susan Manwaring led a discussion on the Voluntary Sector in Canada as part of a course on Non-Profit Organizations and their Environment at the Schulich School of Business, York University on February 22, 2010.

Bill Fowlis joined the editorial board of the Estates, Trusts & Pensions Journal.

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