Submission for Meeting with Canada Revenue Agency and Finance Canada on Draft Technical Amendments and Federal Budget

NATIONAL CHARITIES AND NOT-FOR-PROFIT LAW SECTION
CANADIAN BAR ASSOCIATION

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PREFACE

The Canadian Bar Association is a national association representing 38,000 jurists, including lawyers, notaries, law teachers and students across Canada. The Association's primary objectives include improvement in the law and in the administration of justice.

This submission was prepared by the National Charities and Not-for-Profit Law Section of the Canadian Bar Association and with assistance from the Legislation and Law Reform Directorate at the National Office. The submission has been reviewed by the Legislation and Law Reform Committee and approved as a public statement of the National Charities and Not-for-Profit Law Section of the Canadian Bar Association.

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I. INTRODUCTION

The National Charities and Not-for-Profit Law Section of the Canadian Bar Association (the CBA Section) is pleased to present this submission to the Canada Revenue Agency (CRA) and the Department of Finance.

These submissions deal with a number of issues arising out of the draft legislation and explanatory notes dealing with technical amendments to the *Income Tax Act* (the "Act") introduced on February 27, 2004 and arising out of the federal budget introduced on March 23, 2004 (the "Budget") and the Notice of Ways and Means Motion and Explanatory Notes tabled by the Department of Finance.

II. FEBRUARY 27, 2004 TECHNICAL AMENDMENTS

A. Eligible Amount of Gift

Submissions were made in respect of the December 20, 2002 proposals by the CBA Section and by the Joint Taxation Committee of the Canadian Bar Association and the Canadian Institute of Chartered Accountants. We reiterate the earlier submissions.

Subparagraph 248(31)(a)(iii) of the Act will provide that the amount of the advantage in respect of a gift or monetary contribution will include an amount that is "in any other

way related" to the gift or monetary contribution. The CBA Section believes that this wording is too broad and will lead to considerable uncertainty. Transactions that have taken place well before the gift might be given retroactive effect to invalidate what would otherwise be a valid gift if the 80% threshold is not met, or reduce the value of the gift otherwise. We would like to discuss the administrative approach to be taken by CRA in construing this provision and whether it intends to issue guidelines for clarification. In that regard, we note the position adopted by CRA in respect of "related business" and the administratively-derived concepts of "linked" and "subordinated".

The CBA Section remains concerned about the requirement imposed on a donee to determine the value of an advantage provided by a third party, particularly where the donee may be completely unaware of the advantage and not able to determine its value. This could be the case, for instance, where a payment is made to a donee pursuant to a court order, to avoid a penalty or fine. The donee may be completely unaware of the motivation of the donor.

B. Deemed Fair Market Value

Subsection 248(35) of the Act will deem the fair market value of property that is the subject matter of a gift to be its cost in certain circumstances, for purposes of subsection 248(30), paragraph 69(1)(b) and subsections 110.1(2.1) and (3) and 118.1(5.4) and (6). Since it will not apply for purposes of paragraph 69(1)(c), the donee will determine its cost under general principles. We assume the donee will issue its official receipt based on the "real" fair market value and will not be required to inquire into the deemed fair market value to the donor. That information will not normally be available to the donee and will be within the exclusive knowledge of the transferor.

The deeming rule will apply if the property was acquired under a gifting arrangement within the meaning in section 237.1 of the Act or, except in the case of death, the

taxpayer acquired it less than three years before the date of the gift or it is reasonable to conclude that at the time the taxpayer acquired the property, the taxpayer expected to make a gift of the property.

The CBA Section is concerned about the scope of the definition of "gifting arrangement" for this purpose, which raises the same issues that are raised under the tax shelter provisions. If the concept of a gifting arrangement, which is necessarily vague because of the broad purpose of the tax shelter rules and the objective of requiring disclosure, is imported into the rules for the determination of the fair market value of property, there will be considerable uncertainty. It is one thing to register a tax shelter; it is quite another thing to affect the value of a gift. The definition refers to statements or representations made or proposed to be made in connection with the arrangement, without regard to the person making those statements or representations. We are concerned that there could be a gifting arrangement where the only statements or representations are made by an advisor to the donor, and not by a "promoter". From discussions with CRA about tax shelters, it is clear the rules are extremely broad and it is difficult to determine their limits.

We think it would be preferable to limit paragraph 248(35)(a) to situations in which the property was acquired under a gifting arrangement involving representations by a third party. In that regard, the same concern mentioned above in connection with "a related" advantage arises with respect to the words "considered to relate to" a gift. While broad concepts may be appropriate for the disclosure required for tax shelters in general, we think they are too broad and uncertain to determine the fair market value of property.

This proposal prevents a donor from making a gift of property acquired at any time, if there was <u>any</u> expectation that it might be the subject matter of a gift, subject to the exclusions in subsection 248(36). At a minimum, expecting to make a gift should be a

primary motivation. In many situations, a taxpayer will have some expectation of making a gift, even if it is not a motivating reason for acquiring the property. We suggest that the wording be modified to require that it may reasonably be considered that one of the main reasons for the acquisition of the property was to make a gift.

Alternatively, we suggest a different approach consistent with the earlier "art-flip" amendments. The concept in subsection 47(5) of the Act appears to have been developed differently. The $1,000 threshold for personal-use property does not apply to property acquired by the taxpayer or a non-arm's length person in circumstances in which it is reasonable to conclude that the acquisition relates to an arrangement, plan or scheme that is promoted by another person or partnership and under which it is reasonable to conclude that the property will be the subject of a gift. It is not clear why this concept has not been used in subsection 248(35). We feel it would be preferable to provide that the deemed fair market value rule will apply to excluded property as defined in subsection 47(5), rather than to transfers involving gifting arrangements or expectations to make gifts.

It is not clear whether the onus lies on the donor or on CRA to establish whether it is reasonable to conclude that the taxpayer acquired property with the expectation of making a gift. We believe the onus should be on CRA to establish that expectation. However, if an assessment is issued, the onus is generally on the taxpayer to rebut assumptions on which it is based. In the absence of direct evidence from the donor, this would require an inference to be drawn from all of the surrounding circumstances. There can be situations in which property was not acquired with any expectation of making a gift, and circumstances have changed. On the other hand, as noted above, it will not be unusual for a taxpayer to acquire property with some expectation of making a gift at some point in the future, however remote or insignificant that expectation might be at the time of acquisition. This is reminiscent of the concept of secondary intention in

determining whether property is acquired on capital account or on income account and whether an intention to resell at a profit was a motivating factor when it was acquired. It is neither fair nor equitable to penalize a taxpayer who acquires property with only a limited expectation of ultimately making a gift, particularly where there is no gifting arrangement and the property is not part of any "scheme".

C. Substantive Gift

Subsection 248(38) of the Act will extend the deeming rule to include a gift of cash accompanied by a transfer of property that itself would have been subject to the deeming rule.

While this concept extends the deemed fair market value based on cost, we are concerned that it may be difficult in some cases to determine when there will be the required degree of linkage between the cash gift and the subsequent transfer of property.

D. Holding Period

The CBA Section considers that there should be a defined holding period after which the "tainting" resulting from an acquisition pursuant to a gifting arrangement or an acquisition with some expectation of making a gift would disappear. If the concept in subsection 47(5) is substituted and the three year rule is retained, we think a taxpayer should be deemed not to have acquired property for the purpose of donating it if it has been held for more than three years.

We also think the holding period (particularly the three year period under the current proposals) should deal with non-arm's length transactions. For instance, if an individual transfers property to a spouse or to a corporation, there seems to be no reason why the three year period should not include the prior period of "group" ownership, rather than only individual ownership. If the idea is that the passage of three years will ensure that

the original cost will no longer be a determining factor in establishing the fair market value at the time of the gift, that three year period should not arbitrarily start to run merely because there is a reorganization within a closely-held group.

The CBA Section is also concerned about the arbitrary three year period. We can envision situations in which property will be acquired in circumstances in which it clearly will have appreciated within three years, and this arbitrary rule, with no opportunity whatsoever to establish the real fair market value, will penalize *bona fide* donors who acquire legitimate works of art or other assets that have clearly appreciated. We believe it would be preferable to provide a mechanism through which a determination could be made, similar to the mechanism used for cultural property.

Subsections 118.1(10) and (10.1) contemplate a two year period during which a determination by the Canadian Cultural Property Export Review Board or the Minister of the Environment is effective. We consider it would be appropriate for certain other types of property to be governed by a similar regime. The response to the problems associated with art flips has resulted in very broad proposals, which go far beyond the perceived harm, in valuing works of art, collectibles or other objects that have been promoted in tax shelters. We think many legitimate donations will be adversely affected and in many cases delayed by the three year rule. There should be an exception from the three year period for property that is not acquired pursuant to a gifting arrangement or the type of arrangement contemplated in subsection 47(5). Otherwise, there will be no incentive for astute taxpayers to acquire property below its fair market value with a view to donating it to charity. The exception for cultural property is too narrow. Shares of private companies and other assets will often be no more difficult to value than real

estate. Forcing a donor to wait for three years will have a chilling effect on many donors where there is no issue about value and there are demonstrated reasons for an increase in value.

III. MARCH 23, 2004 FEDERAL BUDGET

A. Notice of Ways and Means Motion Resolution (24)

The budget proposes to deny a deduction claimed by a corporation where there is "trading" in charitable donations. In particular, it is proposed that no deduction will be available "in respect of" a gift made by the corporation after control has been acquired if the property was acquired by the corporation before that time "under an arrangement under which it was expected that control of the corporation would be so acquired and the gift would be so made".

The CBA Section is concerned that this concept is too vague and uncertain. It introduces the same concept of expectation that is discussed above in the context of the deemed fair market value of property. It will often be difficult to establish what the expectation was with respect to a later acquisition of control, at the time property is acquired. While there will clearly be situations in which all of the transactions are linked together and the purpose of the transactions is to permit a purchaser of a corporation to take advantage of previous donations, often through a corporate reorganization involving an amalgamation or a winding up, we are concerned that the rule, as currently drafted, would deny the deduction to a corporation that is not involved in a reorganization and that subsequently earns income against which the deduction would, but for the change of control, have been available.

The rules in section 111 dealing with acquisitions of control that otherwise limit the

availability of losses do not apply where the same business or a similar business is carried on after the acquisition of control, with a reasonable expectation of profit. It is difficult to see why there should be a limit on the availability of donations being carried forward after an arm's length acquisition,
where the corporation carries on the same or a similar business with a reasonable expectation of profit.

If donations are otherwise to be denied, there should be a mechanism similar to paragraph 111(4)(e) of the Act to write up the cost of assets. The proposal appears to be unnecessary in those situations in which subsection 69(11) of the Act would apply.

B. Notice of Ways and Means Motion Resolution (25)

The budget documents contain a number or proposals, most of which were recommended by the Joint Regulatory Table. Our comments are as follows:

1. Compliance

i. Intermediate Taxes and Penalties

a. Tax on Gross Revenue Generated from Prohibited Activities and for Other Infractions

The proposal to impose a 100% tax on gross business revenue and suspend tax-receipting privileges appears to be harsh for a "second offence", particularly where there is considerable uncertainty about the scope of the concept of a "related business". The repeat offence sanction should apply only where the same business is carried on in a subsequent year. It would be unfortunate if a charity were penalized for two innocent mistakes, in connection with two types of activities, completely separate from each other, if the second activity has no similarity to the first activity. We suggest a mechanism similar to the repeated failure to file rule in subsection 162(8). We also suggest that the Minister be required to put the charity "on notice" of the first contravention, before there can be a "repeated" contravention.

Similarly, we believe that the repeated infraction rules should be clarified for situations involving acquisitions of control, the provision of an undue personal benefit, a gift to a non-qualified donee and the other circumstances in which the penalty is more severe for a repeat occurrence. It will be important for the charity to know that it is subject to a repeated infraction tax. The proposals refer to a repeat infraction as an action in a particular year that gives rise to a tax or penalty in respect of which an assessment was previously raised in a preceding taxation year. We think the provision should go further and require the notice of assessment to make it clear to the charity that a repeat infraction will subject it to a harsher penalty and identify exactly what the infraction was and what the "action" in respect of it was.

The CBA Section is concerned that there will be a fundamental shift in the level at which decisions will be made about intermediate sanctions. At present, decisions are made through a centralized process at CRA when there is a revocation of registration. If decisions to assess taxes or penalties or to suspend tax-receipting privileges are made by field auditors or others who are not as well-versed in the rules, we are concerned that the playing field will not be level. CRA has indicated that in respect of civil penalties under subsection 163.1, it will ensure that the same factors are applied nation-wide before any penalties are assessed. We suggest that a similar administrative process be used in assessing tax or penalties against registered charities under the intermediate sanctions.

b. Suspension of Tax-Receipting Privileges for Improper Use of Donated Funds

The CBA Section is concerned that a qualified donee whose privileges have been suspended might issue official receipts. We do not think it is fair to assume that members of the public will necessarily be aware of the suspension, notwithstanding information available on the CRA website. Similarly, in the case of smaller organizations, we are not convinced it is appropriate to penalize another qualified donee

that transfers funds to the suspended charity. Although the proposals require the suspended charity to notify potential donors, this may not necessarily occur. We suggest a "safe harbour" rule, during which the donor or other qualified donee will not be penalized for transfers or gifts that are made within a stipulated period after the suspension occurs, and prior to formal announcement on the CRA website, in the absence of actual knowledge which CRA is able to establish clearly, such as in a non-arm's length situation.

The foregoing comments about a level playing field also apply to suspensions.

ii. Transfer of Amounts in Respect of Taxes and Penalties

a. Concept of Eligible Donee

The CBA section is concerned that the restriction on the ability of a registered charity to transfer its property to another organization that is expressly contemplated in its letters patent or other constituting document may create an element of impossibility. The concept appears to be that a charity can direct its tax or penalty to another charity. There seems to be a presumption that all funds raised for "charity" are necessarily raised for charitable purposes. This is inconsistent with the provisions in the Act, which include as qualified donees municipalities, registered Canadian amateur athletic associations and other entities or organizations that are not "charitable". Some foundations have objects permitting them to support only qualified donees that are not charities. The Act deems a disbursement to a qualified donee to be a charitable purpose, but this does not affect charity law. We are concerned that there will be an arbitrary restriction on the relief available to a charity required to pay taxes and penalties to those that are legally able to transfer funds to registered charities.

We assume amounts transferred under these rules by one charity to another will not be counted in determining the disbursement quota of the paying charity or the receiving

charity and will not be regarded as "gifts". This assumption should be clarified.

b. Limitation to Registered Charities

See above.

iii. Revocation of Registration for Severe Breaches

a. Optional Direction of Assets by a Revoked Charity to an Eligible Registered Charity

We have the same concerns about transfers to eligible registered charities as in the case of taxes and penalties.

b. Jeopardy Collection Procedures

We assume that there will be a mechanism similar to the rules in section 225.2 of the Act, which will enable a registered charity to contest an order permitting the Minister to collect the revocation tax within the one year grace period. Under subsection 225.2(3), a judge may order that the notice of assessment need not necessarily be sent to the taxpayer if doing so would further jeopardize collection. The CBA Section is concerned that since these proceedings are taken *ex parte*, there is potential for unfairness. The fact that the charity whose registration has been revoked will retain the opportunity to satisfy the liability by transferring assets to an eligible donee will be meaningless if the Minister has invoked the jeopardy procedure and the charity is not aware of the assessment. The charity should have the right to challenge the order before any collection steps are taken.

iv. Appeals

a. Accessibility and Affordability of Process through Creation of Impartial CRA Internal Reconsideration Group

The CBA Section understands from informal discussions with CRA officials and the vague reference in the budget materials to the appeals regime that it will apply not only to taxes and penalties but also to suspensions. We assume the usual provisions allowing

an appeal to the Federal Court of Appeal from the decision of the Tax Court of Canada will apply.

b. Mandatory Objection Process before Filing Appeal to Federal Court of Appeal as at Present

The CBA Section understands that where there is a refusal to register or a registration is to be revoked, the charity will be required to file a notice of objection before appealing directly to the Federal Court of Appeal. We assume the usual rules will apply after the notice of objection has been considered, except that the appeal will be made directly to the Federal Court of Appeal rather to the Tax Court of Canada.

v. Transparency

a. Release of Information Pertaining to Organizations that are Denied Registration

The CBA Section is concerned that disclosing information about organizations that have been denied registration may inadvertently identify the organization. The use of "severed" advance rulings indicates that in many cases so much information is deleted that it is difficult to determine what the ruling was about. In many cases, the details of an organization seeking registration will be so specific that it may be possible to identify the organization from its objects or activities. We assume CRA will err on the side of caution, and delete all information that could conceivably identify the unsuccessful applicant and that this will extend to information "disclosed" by the organization in the course of making the application, including all correspondence and other material submitted by the organization in support of its application.

b. Increasing Public Information and Sector Education

We agree that it is desirable to increase public awareness and provide more assistance in educating the sector. However, we are concerned some of the rules are so complex that even sophisticated charities and advisers often have difficulty understanding or

applying them. We expect there will be numerous instances in which risk of revocation of registration or liability for intermediate sanctions will arise as a result of ignorance of the rules or lack of understanding of their significance. The CBA Section recommends a transitional period, during which the new sanctions are not applied without a warning and an opportunity to learn from mistakes.

2. Disbursement Quota Rules

As a general comment, we are concerned about the increasing complexity of the concept of the disbursement quota and the technical problems that it creates. We have previously identified a drafting problem in the formula for expending 10 year gifts, and it seems inevitable that the continued refinement of these rules will result in more unintended results that will be identified only in the context of particular situations. While subsection 149.1(5) provides some discretion for the Minister to grant relief, it is not as of right and a charity that is technically offside runs the risk of revocation. We think the entire concept of disbursement quotas should be revisited.

i. Application of New 3.5% Test

The budget material refers to a periodic review of the rate. We understand this will be accomplished by regulation rather than amendment to the Act, to provide flexibility. If this is not the case, we recommend that this be considered.

ii. New Rules for Realized Capital Gains from Endowments

We suggest it would be preferable to refer to arrangements involving gifts for more than 10 years rather than endowments. Not all gifts made for more than 10 years are necessarily endowments, since the word "endowment" has a specific meaning in charity and trust law.

We are concerned that the mechanism to reduce the 80% disbursement requirement that now applies to the expenditure of proceeds from the disposition of such property,

by the lesser of 80% of the capital gain realized on the disposition and 3.5% of the value of all property not used directly in charitable activities or administration, is confusing and unclear. We would like to discuss this in more detail, to try to understand precisely how this proposal is intended to work.

The CBA Section also notes that the proposals do not deal with the problem of insufficient income to meet the disbursement quota for a charitable foundation based on a deemed return on its assets. The reduction in the rate from 4.5% to 3.5% is a step in the right direction, but will not solve the problem faced by charities that adopt a total return investment strategy and seek capital gains rather than "income" in the traditional sense, or charities that are required to retain investments that produce capital gains but little income. This illustrates the problem with the complexity of the current rules and the reliance on administrative relief in subsection 149.1(5) of the Act.

iii. Extension of 3.5% Quota to Charitable Organizations

The 3.5% test will now be applied to charitable organizations, subject to a grandfathering provision that will begin after 2008 for charitable organizations registered before March 23, 2004. We question the purpose of the distinction between charitable organizations and public foundations and would like to discuss whether it might be appropriate, or whether the Department of Finance has any plans, to merge these two concepts into a single concept.

iv. Transfers between Registered Charities

The budget proposes to ensure that all transfers from one registered charity to another are subject to a disbursement requirement. We understand the current exception for specified gifts will remain and transfers of "endowments" will now be permitted. The proposal to require a charitable organization to expend 80% of amounts received from other charities, as is now required for public foundations, further blurs the line between charitable organizations and public foundations. Since a charitable organization is

required to devote its resources to charitable activities, and many smaller charitable organizations receive support from public foundations or larger charitable organizations, we are concerned this will prevent those smaller organizations from carrying out their charitable purposes with the flexibility they currently enjoy. The definition of "income" in paragraph 149.1(12)(b), as applicable to subsection 149.1(6), contemplates that income of a charity excludes amounts received by it from another charity as a specified gift, a gift of capital received as a bequest or inheritance or a 10 year gift and a gift that is not made out of the income of the other charity. We would like to discuss whether these rules will be affected by this change.

The CBA Section understands the original concept of the disbursement rules was to provide more leeway to charitable organizations than to charitable foundations. We are concerned this change in direction and the blurring of the lines between public foundations and charitable organizations may have unintended results and create unforeseen problems for some charitable organizations.

It is proposed that an "endowment" received by one registered charity from another registered charity will be treated in the same manner as if it had been received directly from the original donor. This will presumably be subject to the wishes of the donor and any restrictions that may have been imposed by the original donor, who may not have contemplated the transfer from the first charity to the second charity. The precise way in which this change will be implemented is not clear and we would like to discuss it.

3. Direct Designations

We assume the proposal to treat amounts that are subject to direct designations as if they were bequests or inheritances for disbursement quota purposes will apply also for purposes of the definition of income in paragraph 149.1(12)(b) of the Act.