THE CANADIAN BAR ASSOCIATION
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June 20, 2007

Mr. Bob Hamilton
Senior Assistant Deputy Minister
Tax Policy Branch, Department of Finance
16th Floor, East Tower
140 O'Connor Street
Ottawa, ON K1A 0G5

Dear Mr. Hamilton:

Re: 2007 Federal Budget — Excess Business Holdings

I write on behalf of the Charities and Not-for-Profit Law Section of the Canadian Bar Association regarding the March 19 federal budget proposals eliminating capital gains on donations of listed securities to private foundations and the related proposals dealing with excess business holdings. We are encouraged by the extension of tax relief for donations to private foundations and acknowledge the concern of the government with respect to possible "self-dealing" problems, particularly with reference to public companies. The concern relates to the risk that individuals with holdings in a company would exert undue influence over the company's management for their own benefit if these individuals are connected to a private foundation with holdings in the same company.

While these concerns may be legitimate, we question whether the excess business holdings regime should be extended to shares of *private* companies owned by private foundations. We see no policy rationale for applying the same rules to shares of private companies as those applying to listed securities. This is particularly the case where a private company is wholly owned by a private foundation, as we discuss further below.[1] There is no special tax incentive for donations of shares of private companies, and extending the excess business holdings rules to the shares of private companies seems unnecessary and misdirected.

[1] The excess business holdings rules would apply in cases where the private foundations holds 20% or more of any share class in a company, even if *no* shares are held by non-arm's length persons.

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Further, we believe there are adequate rules in place dealing with the ownership of shares of private companies by private foundations. These include the rules dealing with acquisitions of control (ITA sections 149.1(4)(c) and 149.1(12)(a)), with the payment of dividends (sections 188.1(3) and 149.1(12)(a)), with non-qualified investments (sections 149.1(1) and 189) and with donations of non-qualifying securities (sections 118.1(3), (18) and (19)). If the objective of the proposals is to require a private foundation and non-arm's length persons to divest their combined shares to a level below 20%, in many instances the foundation will not be able to retain shares of private companies received as donations. This is due to the fact that a foundation is often the sole shareholder of a company. There will then be no alternative to winding up the company or trying to sell its shares. Selling the shares will be difficult in many cases and winding up the company will raise other issues. We note the exception in the rules for non-qualified investments where the company is wholly-owned by the foundation. Further, Bill C-33 will exempt from the deemed valuation rules a gift of shares where the donor acquired the shares from treasury and controlled the company before the gift, if the property for which the shares were issued would not be subject to those valuation rules. This recognizes the role of private companies owned by registered charities, including private foundations. We submit there should be an exception from the excess business holdings rules for wholly-owned companies, if those rules are to apply at all to shares of private companies.

We foresee instances where the new proposals would prevent foundations from managing their donations in the most efficient manner, or receiving them altogether, in circumstances where the policy rationale of preventing "self dealing" does not appear to apply. The first instance relates to donations to a private foundation of all of a private company's shares as an alternative to the company donating its assets to the foundation. Individuals often own real estate or portfolios of listed securities indirectly through private companies. The most straightforward way for a private foundation to acquire and retain assets owned by a donor indirectly is to receive a donation of shares of a private company that itself owns the assets. There is no tax loss to the government in permitting an indirect transfer of a portfolio of listed securities or real estate to a private foundation because, unlike a direct donation of listed securities, the donor will realize any inherent capital gain.[2] However, under the existing rules, the gift will not be recognized if the shares are non-qualifying securities. The foundation will be subject to the rules dealing with non-qualified investments and the penalty tax based on dividends received. In these circumstances, there is no prospect of self-dealing by a donor when no person other than the foundation owns any shares of the company. Accordingly, there does not appear to be any policy rationale for preventing such a transaction. If the concern is that a donor will "control" the company through the foundation or the company will own listed shares that would be caught by the new rules if owned directly, we suggest the government consider a more focused approach.

The second instance relates to private foundations wishing to form a wholly-owned corporation and receive its shares in exchange for assets, such as donated real estate or a portfolio of listed securities. There are often business and commercial reasons (such as limited liability) for a private foundation to hold an asset indirectly. The existing rules dealing with acquisition of

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[2] Unless an election is made under ITA section 118.1(6) to treat the gift as occurring at less than fair market value.

control are also relevant. If a private foundation transfers assets for no consideration to a company of which the foundation did not acquire control, other issues arise. Again, the proposals would prevent a private foundation from holding all the shares of this private company when no "self-dealing" concerns exist in the circumstances.

In conclusion, we see no policy reason for a private foundation that owns all the shares of a private company to be considered to be "self-dealing" in the sense contemplated by the policy behind the excess business holdings rules aimed at listed companies. We recommend that the excess business holdings rules not apply to shares of private companies at all. In the alternative, they should apply only in defined circumstances in which some specific type of potential abuse is possible, and not where the foundation is the sole shareholder.

If the government believes it necessary to enact rules limiting ownership in private companies, we recommend grandparenting existing arrangements, so the rules would not apply to shares that, on March 19, were owned by a private foundation, or the foundation had an enforceable agreement under which they could be acquired. We submit it is not appropriate to penalize private foundations that had arrangements in place where it was unanticipated that the new regime might limit their ability to retain the shares.

Finally, we are concerned about the application of the concept of non-arm's length to registered charities owning shares of corporations, including private foundations. The budget material states that a non-arm's length person will include a person that "controls" the foundation. We assume that the extended concept of "control" in ITA section 256(5.1) will be used, namely "controlled, directly or indirectly in any manner whatever." This same concept was used in Bill C-33 concerning the designation of charities and raises similar problems. "Control" is a concept that is very difficult to apply to a registered charity, whether it is a private foundation or otherwise. Looking at the concept of "non-arm's length" itself, it is a question of fact under ITA subsection 251(1) whether persons not related to each other deal with each other at arm's length. Since a private foundation cannot be "related" to any person under the current definition, it will always be a question of fact whether a private foundation deals at arm's length with another person. We submit that the concept of "arm's length" is sufficiently difficult to address and introducing the concept of deemed control for this purpose will cause confusion and add another level of complexity that is unnecessary.

Yours very truly,

(*Original signed by James M. Parks*)

James M. Parks
Chair, National Charities and Not-for-Profit Law Section

cc. Baxter Williams
Director, Personal Income Tax Division, Finance Canada