December 1, 2011

Sean Keenan
Director, Personal Income Tax
Finance Canada
140 O'Connor St
Ottawa, Ontario K1A 0G5

Dear Mr. Keenan:

Re: Inter-Charity Transfers – Anti-Avoidance Rules

I am writing to you about new anti-avoidance rules for inter-charity transfers, in my capacity as Chair of the Charities and Not-for Profit Law Section of the Canadian Bar Association (CBA Section).

CBA is a national association representing over 37,000 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. The CBA Section represents lawyers from across Canada who advise or serve on the boards of charitable and non-profit organizations.

We appreciate Finance Canada's attention to the submissions by the CBA Section on the Disbursement Quota (DQ) provisions of the *Income Tax Act*. Amendments made as a result of the 2010 Federal Budget and subsequent amendments were welcomed with enthusiasm by the charity community and their advisors.

One major achievement of the DQ amendments was to eliminate multiple DQ rules leaving one simple DQ rule, namely the requirement to disburse 3.5% of the value of amounts not used directly on charitable activities or administration.

Notwithstanding this simplification, a new complication was added with the new anti-avoidance rules for inter-charity transfers between non-arm's length charities proposed in the 2011 budget. The complication arises in paragraph 149.1(4.1)(a)-(d). This has introduced a new DQ rule which has led to more confusion and ambiguity and possibly unintended consequences.

With the information which has been made available, we are unable to discern any policy considerations which would outweigh the advantages of these rules and recommend they be eliminated.

Subject to clarification of the policy reasons for these provisions, our comments about the current wording of paragraphs 149.1(4.1) (a)-(d) aim to clear up some ambiguities that remain in the legislation.

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1. Paragraph 149.1 (4.1)(a) provides that the registration of a registered charity may be revoked if it has entered into a transaction (including a gift to another registered charity) and it may reasonably be considered that a purpose of the transaction was to avoid or delay unduly the expenditure of amounts on charitable activities.

   (a) The term "transaction" is very broad. For example, it could include an endowed gift from a donor or a transfer of an endowment from one charity to another. Clearly a purpose of these gifts or transfers would be to hold the corpus of the gift for a period of time or even forever.

   Presumably this is not intended to prevent donors from making long-term restricted gifts or endowments, nor is it intended to preclude the charity receiving the gift from transferring it to another charity which would continue to hold it in accordance with its original terms.

   Secondly, the rule is presumably not intended to be applied to funds which a charity decides to set aside to create an internal endowment from time to time.

   It would be helpful to confirm that the provision is not intended to catch such gifts or transfers.

   We suggest giving examples to confirm that the provision is not intended, *inter alia*, to frustrate the transfer of property (in the form of an endowed gift from one charity to another) where the intent is for the recipient charity to agree to hold the gifted property on the same conditions and terms to which the original recipient charity (i.e. transferor) was subject.

   (b) It is unclear what is meant by “to avoid or delay unduly” expenditures on charitable activity. Avoid or delay relative to what? The concepts of avoidance and delay are comparative concepts. There is an avoidance or a delay only where there is a departure from an established benchmark or standard. A charity cannot avoid or delay an expenditure it is not otherwise required to make within a particular time.

   Prior to the recent DQ reform, the DQ rules provided a standard. In addition, to other amounts, charities were required each year to expend 80% of the previous year’s receipted donation and between 80% to 100% of gifts received from other charities in the previous year. Transactions designed to defeat those specific expenditure requirements could be viewed as transactions designed to avoid or delay.

   Now that the DQ is merely 3.5% of investment property, it is less clear what it means to avoid or delay expenditures on charitable activities. The provision may be meant to apply to attempts to defeat the 3.5% expenditure requirements. It would, however, be helpful to give examples of the types of transactions that represent the “harm” the provision is intended to prevent.

2. Under paragraph 149.1(4.1)(b), the recipient charity is equally at risk if it may reasonably be considered that a purpose of entering into a transaction (including acceptance of a gift) with another registered charity to which paragraph (a) applies was to assist the other registered charity in avoiding or unduly delaying the expenditure of amounts on charitable activities. This is the mirror image of paragraph (a), viewed from the perspective of the transferor charity but with implications for the transferee charity (presumably for aiding and abetting the harm perpetrated by the transferor.). It now seems that both paragraphs 149.1(4.1)(b) and 149.1(4.1)(d) could apply to a recipient charity. The former would apply based on a purpose of the transferor charity making the gift to it (or worse, if it is reasonable to consider

that the purpose in making the gift), regardless of whether the transferee charity spends the money it receives. The latter would apply if the transferee charity is not dealing at arm's length with the transferor charity, and does not spend a sufficient amount. Since no carve out for a designated gift is allowed in paragraph (b), we suggest that paragraph (b) is redundant.

3. Under paragraph 149.1(4.1)(d), registration of a charity can be revoked if it receives a gift from another registered charity with which it does not deal at arm's length, and it has not expended an amount equal to 100% of that gift before the end of the next taxation year in addition to its DQ for those two taxation years, either on its own activities or by gifts to other qualified donees with which it deals at arm's length. Designated gifts are an exception.

   This provision should be clarified. We are particularly concerned about use of "non-arm's length". The definition of non-arm's length in the *Income Tax Act* does not fit well with non-share capital organizations and the term often leads to confusion and uncertainty about how to determine whether one charity is dealing at arm's length with another. The jurisprudence, based largely on situations involving corporations with share capital, is unhelpful.

   Examples of the harm to be addressed should be in the provision. A transfer from a parallel foundation to a hospital would fulfill what the foundation is set up to do (i.e., support the hospital) and would meet the foundation's charitable purpose. The subsequent expenditure by the hospital would meet the hospital's charitable purpose of providing health care. We have difficulty understanding why Finance Canada believes an anti-avoidance rule is necessary in such circumstances and we believe it is unnecessary.

   Also, the paragraph refers to expenditure of an "amount". This does not take into account the possibility that the transfer may not be cash, but rather an asset used by the recipient charity on its own charitable activities. In that case, even though the recipient charity is using the transferred property, it would need to spend cash to satisfy the requirements of this paragraph. There is no sound policy reason for this result.

   Ultimately, we do not see the necessity for this provision. There was a DQ obligation for inter-charity transfers, to protect the 80% DQ applicable to receipted donations. With the 80% DQ for receipted donations eliminated, there is arguably no need for a provision for inter-charity transfers. The only DQ advantage to be attained through inter-charity transfers is to help the transferor charity meet its 3.5% DQ. There are penalties for abusive inter-charity transfers and paragraph 149.1(4.1)(a) permits deregistration for transfers aimed at delaying expenditures. We believe paragraph 149.1(4.1)(d) is unnecessary. If the mischief is addressed by 149.1(4.1)(a), there is no need for 149.1(4.1)(d).

4. It is not clear why the non-arm's length requirement should matter to the policy objectives behind paragraphs 149.1(1)(a) and 149.1(12)(b). Given the definition of "designated gift" in subsection 149.1(1), only gifts between non-arm's length charities can qualify as designated gifts. The concept of a designated gift matters only for purposes of paragraphs 149.1(1.1)(a), 149.1(4.1)(d) and 149.1(12)(b). The non-arm's length requirement is already contemplated in paragraph 149.1(4.1)(d).

5. It is problematic that the expenditure obligation created under paragraph 149.1(4.1)(d) is equal to the fair market value of the gifted property. This description of the expenditure obligation creates problems where a transfer for partial consideration is made from one charity to another non-arm's length charity. Presumably in such circumstances the expenditure obligation should apply only in relation to the net amount of the transfer. It may be that such a transfer would not qualify as a "gift" in the first place given the apparent intention of proposed subsection 248(40). However, we request clarification on this point.

6. What Finance Canada would deem abusive with respect to inter-charity transfers lacks clarity. The amendments seem to address a concern that the 3.5% test will not be met if funds are moved within a non-arm's length group. For instance, charity A might try to meet its 3.5% DQ test by transferring funds to charity B, with which it does not deal at arm's length, and charity B might simply retain the funds because it has met its own DQ. The new rules will require charity B to expend the funds in addition to meeting its own DQ. This may not be appropriate if the objective is to ensure that the 3.5% is actually spent on charitable activities. If that is the case, the wording should be refined to provide that the anti-avoidance rules apply only to the extent that the transferor charity claims credit for the gift or other transfer in meeting its own DQ requirement in the year. There is no policy reason to require capital to be spent by the transferee if the transferor was not required to spend it to meet its own DQ.

7. Paragraph 149.1(4.1)(d) will prevent a charity that has received (or created) endowment funds from ever transferring them to a non-arm's length charity except as a designated gift. This may have made sense when there were restrictions on transfers of capital (e.g. enduring property) and the 80-20 test was in place. It does not make sense now. Consider a situation where a registered charity has funds that must be held in perpetuity or for a long time and a reorganization is contemplated through which the funds would otherwise be transferred on the same terms to a non-arm's length registered charity. In such a case, the recipient charity would be forced to spend an amount equal to the fair market value of that property. This would be required regardless of the implications for the DQ of the transferor charity unless the transfer is a designated gift, even if it has no impact on the transferor's DQ (except by reducing its assets pool and the base for its 3.5% test in future). The transferee charity would have to calculate its 3.5% test based on the property it receives, even if it was a designated gift. This rule will impose a serious burden on potential reorganizations or transfers of endowment funds unless the transferor charity designates the gift.

8. There is no sound policy basis for restricting the ability of a registered charity to transfer its endowment funds to a non-arm's length registered charity where there is no adverse impact on the DQ position of the transferor. This should not depend on whether a third party has imposed the restriction or the transferor charity has imposed that restriction itself. The funds to be held on certain terms (whether in perpetuity, for a fixed term or subject to other restrictions) should be capable of transfer to another registered charity, whether dealing at arm's length or not with the transferor charity, if there is no avoidance of the relaxed DQ requirement. Since the DQ requirement now is that each registered charity expend at least 3.5% of the average value of its investment assets, concerns about accumulations appear to be secondary, and arguably non-existent. There seems to be no reason now for a transferor charity to make a designated gift except to back it out of the transferor's 3.5% DQ (and permit the transferee to retain it).

The CBA Section appreciates opportunities for dialogue with Finance Canada on this and other issues. If you have any questions arising out of this submission, the CBA Section would be pleased to discuss them further.

Yours truly,

(original signed by Rebecca Bromwich for Peter Broder)

Peter Broder
Chair, Charities and Not for Profit Law Section