# THE CANADIAN ASSOCIATION OF GIFT PLANNERS
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# LOOKING A GIFT HORSE IN THE MOUTH – LEGAL LIABILITIES IN FUNDRAISING

(Current to March 22, 2004)

## (Power Point Presentation)

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## Overview

- Legal Responsibility of Charities and Directors in Fundraising
- Fundamental Legal Considerations Involved in Fundraising
- Donor's Rights and Remedies in Fundraising
- Avoiding Liability in Fundraising Involving Testamentary Gifts
- Avoiding Liability Involving Donor Restricted Charitable Gifts
- Avoiding Liability in Gift and Fundraising Programs
- Fundraising Liability and Anti-terrorism

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- Civil Penalties for Misrepresentations of Tax Matters by Third Parties Under the *Income Tax Act*
- The Effect of New Regulations under the *Charities Accounting Act*
- Recent Changes to the *Income Tax Act* Affecting Charitable Receipting
- Utilizing Ten Year Gifts in Charitable Fundraising
- Conditional Gifts

**This power point is a selective summary of a recently updated article by the same name available at www.charitylaw.ca**

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## Resource Materials

- www.charitylaw.ca
  - Charity Law Bulletins #8, #9, #13, #17, #21, #23 #35, #40 and #41
  - Article entitled *"Looking a Gift Horse in the Mouth - Avoiding Legal Liability in Fundraising"*
  - Article entitled *"Donor Restricted Charitable Gifts Revisited: A Practical Overview"*
  - Article entitled *"Recent Changes to the Income Tax Act Affecting Charities"*
- www.antiterrorismlaw.ca
  - Article entitled *"Charities and Compliance with Anti-terrorism Legislation: The Shadow of the Law"*

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## Legal Responsibility of Charities and Directors in Fundraising

- Improper or negligent actions by development officers or fundraisers may expose a charity and its directors to legal liability
- The court held in *The Aids Society for Children* (Ontario) that
  - Although a charity does not hold its charitable property in trust for its charitable purpose, a charity has a fiduciary obligation to apply donations for its charitable purposes

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– **A fiduciary has a legal obligation to put the interests of others ahead of the interests of the fiduciary**
– **There is little practical distinction for directors between being a trustee and having fiduciary obligations**
– **A charity and its directors have a fiduciary obligation to account to the public for all funds raised from donors**
– **Charities and directors therefore have a fiduciary obligation to donors to ensure that donations are applied for the charitable purposes of the charity**

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– **It is essential for charities and their directors to review charitable objects on a regular basis and amend those objects as necessary**
– **Third party fundraisers and subcontractors are agents of the charity and may cause liability for both the charity and its board of directors personally**
– **Fundraising contracts which provide for unreasonable compensation may be voidable based upon both violation of public policy and/or misrepresentation**

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- **Misrepresentation is determined by the perception of the donor, not by the intent of the charity or its directors in receiving the gifts**
- **The fiduciary duty of a charity and its board of directors to account for donations applies to the gross amount of donations raised by third party fundraisers, not to the net amount that the charity may be entitled to pursuant to a fundraising contract**
- **Fundraising costs of between 70% to 80% rendered the contracts void as being contrary to public policy**

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- **The directors were found personally liable for unreasonable fundraising costs in the amount of $766,000**
- **Fundraising companies were required to repay unreasonable fundraising costs**
- **The directors were subjected to a penalty of $50,000.00 under the *Charities Accounting Act* (Ontario)**

• **The court in *National Society for Abused Women and Children* confirmed**
  - **Fiduciary obligation of directors to account for unconscionable fundraising costs**

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- Fundraising contract was declared void *abinitio* as being contrary to public policy
- Donors are entitled to know about fundraising and administrative costs when making donations

- For more information on these cases, see Charity Law Bulletins #9, #13 and #17 at www.charitylaw.ca
- The "buck" stops with the board of directors of a charity after everyone else has left the charity
- The board of directors must therefore be made familiar with all fundraising programs and the liabilities that are associated with those programs

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## Fundamental Legal Considerations Involved In Fundraising

- Fundraising is not an end in itself
- Fundraising must comply with the applicable corporate objects and powers of the charity
  - The fundraising program must not be *ultra vires* the charitable objects of the charity
  - The charitable purpose being furthered by fundraising must not be *ultra vires* the charitable objects
  - A donor restricted gift resulting from fundraising must not be *ultra vires* the charitable objects

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- **Fundraising must not violate applicable statutory provisions**
  - **Specific charitable statutes affecting fundraising**
    - ***Charities Accounting Act* (Ontario) and applicable regulations**
    - ***Charitable Gifts Act* (Ontario)**
    - ***Religious Organizations Land Act* (Ontario)**
    - ***Income Tax Act* (Canada)**
      - **Exposure to civil penalties for misrepresentation of tax matters by third parties**

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- ***Charitable Fund-raising Act* (Alberta)**
- ***The Charities Endorsement Act* (Manitoba)**
- ***Charities Act* (PEI)**
- ***Charitable Fund-raising Businesses Act* (Saskatchewan)**
- ***Anti-terrorism Act* (Canada)**
- ***Taxation Act* (Quebec)**

– **Uniform Law Reform Commission is studying the standardization of fundraising legislation across Canada**

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– **General statutes affecting charitable fundraising**
  - ***Trustee Act* (Ontario)**
  - ***Securities Act* (Ontario)**
  - ***Insurance Act* (Ontario)**
  - ***Loan and Trust Corporations Act* (Ontario)**
  - ***Competition Act* (Canada)**
  - ***Personal Information Protection and Electronic Documents Act* (Canada) *(PIPEDA)***

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- **Provincial Privacy Legislation**
- ***Charities Registration (Security Information) Act* (Canada)**
- ***Business Names Act* (Ontario)**
- ***Competition Act* (Canada)**

- **Fundraising must not involve gifts that are contrary to public policy**
  – **Charitable gifts involving discrimination**
  – **Charitable gifts involving illegal activities**

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## Donor's Rights And Remedies In Fundraising

- **General exposure to liability involving donors**
  - **Misrepresentation involving issuance of charitable receipts and/or the amount**
  - **Failure to comply with donor restrictions**
  - **Failure to disclose excessive fundraising costs**
  - **Detrimental reliance upon charitable endorsements**
  - **Detrimental reliance upon improper tax advice involving donations**
  - **Breach of fiduciary duty and/or breach of trust in applying funds to charitable purposes**

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- **Donor's statutory rights**
  - ***Charities Accounting Act* (Ontario)**
    - **Section 6 of the CAA (public inquiry)**
    - **Section 10 of the CAA (alleged breach of trust)**
    - **Section 4(d) of the CAA (noncompliance with donor directions)**
    - **Section 3 of the CAA (formal passing of accounts)**
  - **The *Income Tax Act* (Canada)**
    - **Informal complaint to CRA**
    - **Resulting audits**
    - **Receipting and disbursement violations**

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## Avoiding Liability in Fundraising Involving Testamentary Gifts

- **Reducing legal risks from estate planning programs**
  - **Shift the legal risk away from the charity**
    - **Download the risk to professionals, i.e. accountants or lawyers, to establish evidence of due diligence**
    - **Raise the shield of liability insurance whenever possible, if available**
    - **Return any original wills or codicils to donors or their lawyers**

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- **Avoid circumstances conducive to allegations of undue influence**
  - **Directing work to a particular lawyer**
  - **Paying for a portion of donor's legal costs**
  - **Acting as either an estate trustee (executor) or attorney under a power of attorney**
  - **Preparing a will or power of attorney**
  - **Providing advice on how to structure disposition clauses in a will**
  - **Providing recommendations on how much of the estate should be given to a charity or charities in general**

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- Completing the will guide on behalf of the testator instead of only assisting with background information
- Meeting with the lawyer when the donor gives instructions for the will
- Being present when the will is being signed
- Offering to store the original will, codicil to a will, or power of attorney

- **Managing testamentary gifts**
  - Ensure that a copy of the will is received and carefully review charitable gift provisions
  - Review any applicable donor restrictions before agreeing to receive the gift

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- Require progress reports on the administration of an estate
- Request the distribution of gifts to the estate at the earliest opportunity
- Have legal counsel review estate releases as the charity can not sign an indemnity for money or cause of action beyond what the estate would have otherwise been liable for
- Have legal counsel review estate accounts before signing estate releases
- Review appropriateness of investments
- Ensure that tax credits are used against 100% of income in the year of death and carried back one year, if necessary

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- Make sure that only duly authorized signing officers execute the releases
- Resist voluntarily renouncement of a charitable gift
  - A charity may be asked to renounce a testamentary gift in situations of financial hardship involving family members of the deceased
  - There is no legal authority for a charity to unilaterally renounce a gift
  - Even court authorization for a renunciation of a testamentary gift is unlikely
  - The charity therefore has a fiduciary obligation to pursue testamentary gifts

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## Avoiding Liability Involving Donor Restricted Charitable Gifts

- The difference between unrestricted and donor restricted charitable gifts
  - What is an unrestricted charitable gift?
    - An unrestricted charitable gift is a gift to the charity that is not subject to any restrictions or limitations
  - What is a donor restricted charitable gift?
    - A donor restricted charitable gift that is a gift subject to binding restrictions, conditions or limitations

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- **Instances of breach of trust involving donor restricted charitable gifts**
  - **Diverting a fund to another application**
  - **Withholding a fund**
  - **Pooling restricted funds with funds of another donor**
  - **Encroaching on the capital of an endowment fund**
  - **Altering the terms of a trust deed**
  - **Borrowing from a restricted fund**
  - **Using surplus funds from a fundraising appeal for a different purpose**

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  - **Altering terms of a donor restricted fund without court authorization**
- **Can a donor restriction be unilaterally varied?**
  - **Only a court can vary a donor restricted charitable gift on a *cyprés* application**
  - **Exceptions are**
    - **Gift reverting to the donor on a failed *cyprés* application**
    - **Gift reverting to the donor on the failure of either a condition precedent or a condition subsequent**

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- How should donor restricted gifts be managed once received?
  - Identify the nature of the charitable gift
  - Review and approve donor restrictions
  - Effective ongoing management of donor restricted charitable gifts
    - Deposit into the bank account of the named charity
    - Invest fund in accordance with applicable investment power
    - Do not borrow against restricted fund
    - Commingle restricted funds only in accordance with regulations in Ontario and not with general funds

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- How can donor restricted charitable gifts be avoided in the first instance?
  - Encourage unrestricted gifts
  - Alternatively encourage the use of non-binding directions
  - Advise donors that all gifts are deemed to be unrestricted unless specifically stated otherwise

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- **Preventative steps to reduce liability involving donor restricted charitable gifts**
  - **Public fundraising appeals should state that any surplus funds will be used for the general charitable purposes of the charity**
  - **Ensure that donor restricted gift includes a *cyprés* clause that will allow the charity to amend the purpose**
  - **Ensure that documentation creating donor restricted charitable trusts include the words "in trust"**

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- **Protecting donor restricted charitable gifts**
  - **Background of Christian Brothers series of decisions**
  - **Exigibility of special purpose charitable trusts**
  - **Commentary on the *Christian Brothers Ont.* Court of Appeal decision**
    - **Decision is at odds with common law that states that trust property is not subject to claims against the trustee**
    - **Misunderstanding of what a charitable purpose trust is**
    - **Limited application of the decision provides little comfort**

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– **Impact of the Christian Brothers Ont. Court of Appeal decision**
  - **Claims against charities will likely increase**
  - **Special purpose trust endowments will be at risk to creditors of the charity**
  - **The ability of donors to create enforceable restricted gifts will be weakened**
  - **Donors will be reluctant to give large gifts directly to an operating charity**

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– **Developing a strategy in response**
  - **Utilize an arms length parallel foundation**
  - **Utilize a community foundation or trust company**
  - **Structure gift as a determinative gift with a gift over to another charity**
  - **For more information see <u>www.charitylaw.ca</u> article on *“Donor Restricted Charitable Gifts Revisited: A Practical Overview”***

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## Avoiding Liability in Gift and Fundraising Programs

- **Gifts of Shares**
  - **Gift of shares or interests in a business will be subjected to the *Charitable Gifts Act* (Ontario)**
    - **Charities can not own more than a 10% interest in a business for longer than 7 years**
    - **If a charity owns more than a 50% interest in a business then reporting requirements to P.G.T. apply**
- **Potential liability in relation to improper valuing and receipting of shares of publicly traded companies**

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  - **Need to review CRA position on determining fair market value**
  - **Need to review factors outlined by CRA in valuing shares as set out in Registered Charity Newsletter No. 12**
- **Gifts of real estate**
  - **Three year restrictions on property investments under the *Charities Accounting Act* (Ontario)**
  - **Liability for toxic property and need for environmental assessment**
  - **Need for due diligence searches**
  - **Inability of charity to manage real property**

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- **Receiving used "gifts in kind"**
  - **Need for appraised fair market value**
  - **Potential liability to third parties from using recycled property**
- **Self insured gift annuities**
  - **The difference between self insured and reinsured gift annuities**
    - **Self insured gift annuity**
    - **Reinsured gift annuity**
  - **Legal risks associated with self insured annuities**
    - **Lack of corporate authority**

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    - **Violation of the *Insurance Act* (Ontario)**
    - **Operational financial risks**
    - **Restrictions on foundations issuing annuities**
- **Debt instruments forgivable on death**
  - **Need testamentary instrument to forgive debt**
  - **If not properly forgiven, will become an asset owing to the estate**
- **Bill C-45 Amendments to the Criminal Code (Westray Mines)**
  - **In effect criminalizes situations which previously were only matters of negligence**

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- Charities, directors and officers may be exposed to personal liability
- insurance may not be available for defence costs
- See Charity Law Bulletin #35 at www.charitylaw.ca for more details

- Transferring capital funds between charities
  - Ensure that there are charitable objects to permit the transfer of funds
  - Identify donor restricted charitable gifts
  - Identify impossible or impractical donor restrictions

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- Change of trustees by deed of trust
- Unrestricted funds to be applied for original charitable purpose

- Investment issues in fundraising
  - Determine what investment power applies
  - Review prudent investment standard
  - New delegation of investment decision making under *Trustee Act* (Ontario)
  - See www.charitylaw.ca, Charity Law Bulletin #8 for more details

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- **Managed or pooled investment of charitable funds**
  - **Does the recipient charity have the corporate power to operate a pooled fund?**
  - **Does the investment power of each participating charity permit it to invest charitable monies by pooling monies with a third party?**
  - **Does the *Loan and Trust Corporations Act* (Ontario) have application?**
  - **Does the *Bank Act* (Canada) have application?**
  - **Does the *Securities Act* (Ontario) have application?**
  - **Is court authorization required to pool investment funds of various charities?**

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- **Fundraising legislation**
  - **Ontario:** ***Charities Accounting Act***
  - **Alberta:** ***Charitable Fund-raising Act***
  - **Saskatchewan:** ***Charitable Fund-raising Businesses Act***
  - **Manitoba:** ***Charities Endorsement Act***
  - **Quebec:** ***Taxation Act***
  - **Prince Edward Island:** ***Charities Act***
  - **Federal: Privacy legislation -** ***PIPEDA***

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- **Federal *Competition Act* - Deceptive telemarketing & false or misleading misrepresentation**
  - **Definition of "business" includes the raising of funds for charitable or other non-profit purposes**
  - **Telemarketing is prohibited unless there is statutorily mandated disclosure**
  - **Violation of the *Competitions Act* constitutes a criminal offence**
  - **A due diligence defense is available**
  - **Directors and officers of a charity can be held personally liable**

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  - **The prohibition on false or misleading representation applies to telemarketing, door-to-door solicitation, and items offered for sale by the charity**
  - **A false or misleading representation does not require that it be proven that any person was deceived or mislead**
- **Legal issues involving fundraising on the internet**
  - **Territorial jurisdictional issues**
  - **Intellectual property law issues**
  - **Potential for civil action from the internet**
  - **Domain names, trade-marks and the internet**

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– **Marketing and advertising on the internet**
– **PIPEDA and provincial privacy legislation**

- **Legal issues in sponsorship arrangements**
  – **Distinguishing between receiptable donations and non-receiptable sponsorship payments**
  – **The importance of documenting sponsorship arrangements**
  – **Protecting and licensing trade-marks in sponsorship arrangements**
  – **Liability exposure from sponsorship arrangements**

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- **Fundraising Liability and Anti-terrorism**
  – **Legislation is very complicated, see <u>www.antiterrorismlaw.ca</u> for article *"Charities and Compliance with Anti-terrorism Legislation: The Shadow of the Law"***
  – **Charity and its directors need to have a working knowledge of the anti-terrorism legislation in making a gift to charity**

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- Even gifts that unintentionally end up in the wrong hands through agents of the charity can violate anti-terrorism legislation and create exposure to liability for the charity and its board
- A charity could lose its charitable status
- Directors, donors and fundraisers could be found personally liable
- Need to develop a due diligence checklist to avoid unintentional violations of the legislation
- However, anti-terrorism legislation generally involves strict liability legislation so due diligence is not necessarily a defence

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## Civil Penalties for Misrepresentation of Tax Matters by Third Parties Under the *Income Tax Act*

- In June 2000, section 163.2 of the ITA was introduced to provide for a new civil penalty for third parties, such as tax preparers, advisors, tax shelter promoters and valuators who cause others to misrepresent their taxes owing
- There are two separate penalties, one directed primarily at those who prepare, sell or promote a tax shelter or tax shelter-like arrangement, and the other directed at those who provide tax-related services to a taxpayer

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- **Penalties extend to professional fundraisers, as well as any individuals who are involved directly or indirectly in giving tax advice, including individuals who advise on the tax implications of giving donations to a charity**
- **Penalties also extend to advice given on the internet through the website of a charity, whether in written form or in an exchange between the charity and the donor**
- **CRA's Fact Sheet dated November 2002 and Registered Charities Newsletter No. 16 issued on October 9, 2003 indicate that third party penalties can include charities that receive a donation if "it knows – or if it can reasonably be expected to have known – that the appraised value was incorrect."**

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## The Effect of New Regulations under the *Charities Accounting Act*

- **The impact of regulations under the *Charities Accounting Act* (Ontario) for commingling**
  - **No relief to the common law rule prohibiting directors from receiving remuneration**
  - **Indemnification of directors and officers and liability insurance is now permitted**
  - **Charities may commingle restricted and special purpose funds provided that detailed accounting records are maintained**
  - **However, commingling of restricted funds and general funds are not permitted**

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## Recent Changes to the *Income Tax Act* Affecting Charitable Receipting

**Revised Draft Technical Amendments to the *Income Tax Act* were introduced on February 27, 2004. The major changes brought by the February 2004 Amendments, in addition to the December 20, 2002, February 18, 2003 Budget Amendments and the December 5, 2003 Draft Amendments, are summarized below:**

1. **New Definition of Gift**
   - **The traditional common law definition of a gift requires:**
   - **The donor must have an intention to give**
   - **There must be a transfer of property**

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- **The transfer must be made voluntarily without contractual obligation**
- **No consideration or advantage can be received by the donor**

- **Therefore a contract to dispose of property to a charity at a price below fair market value would not generally be considered a gift at common law for which a charitable receipt could be issued for the difference in price**
- **Similarly, a gift to a charity that entitles the donor to receive a benefit of a material nature would not be a gift at common law for which a receipt could be issued even if the value of the gift significantly exceeded the benefit received**

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- **Draft amendments to the *Income Tax Act* in December of 2002 and December of 2003 create a new concept of "gift" for tax purposes which permits a donor to receive a tax credit under the Act even though the donor receives a benefit, provided that the value of the property exceeds the benefit received by the donor**
- **However, the idea that a gift can provide a benefit back to the donor is foreign to the common law concept of a gift**
- **The draft amendments reflect an importation of the civil law concept of gift which permits a benefit back to the donor**

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- **While a gift with an advantage may be deemed a gift under the *Income Tax Act*, it will not be a gift at common law and therefore there will be no transfer of title**
- **Utilizing a contract in order to transfer title may raise questions of donative intent that could preclude a gift for tax purposes**
- **In order to document the transfer of title where there is an advantage to the donor, and the expectation of a charitable receipt, the alternative of doing so by making use of a charitable trust should be considered**

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## 2. New Split-Receipting Rules

- **The key requirements of what will be recognized as a gift for income tax purposes for split receipting based on the new definition of gift reflected in the December 2002 and December 2003 amendments are as follows:**
  - **There must be voluntary transfer of property with a clearly ascertainable value**
  - **Any advantage received by the donor must be clearly identified and its value ascertainable**

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- **There must be a clear donative intent by the donor to benefit the charity**
- **Donative intent will generally be presumed provided that the fair market value of the advantage does not exceed 80% of the value of the gift**
- **The eligible amount of a gift will be the excess of the value of the property transferred over the amount of the advantage received by the donor**

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- **The amount of the advantage is the total value of all property, services, compensation or other benefits to which the donor, or a person not dealing at arms length with the donor, has received or obtained or is entitled either immediately or in the future as partial consideration for or in gratitude for the gift or that is in any other way related to the gift**
- **Excluded from the value of the advantage is token consideration for the gift calculated on the basis of a "*de minimis* threshold" of the lesser of 10% of the value of the gift and $75.00**

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- **The charitable receipt will now need to identify the advantage and the amount of the advantage as well as the eligible amount of the resulting gift**
- **The advantage can be received prior to, at the same time as, or subsequent to the making of the gift**
- **It is not necessary for a causal relationship to exist between the making of the gift and the receiving of the advantage as long as they are "in any other way" related to each other**

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- **Therefore, if a donor makes a gift in consideration of the charity employing his spouse, or the charity hires his spouse in gratitude of the gift being made in the future, then the value of the advantage would need to include the employment of the spouse**
- **In addition, the advantage could even be provided by third parties unbeknownst to the charity, which fact may necessitate that charities make inquiries of donors if they have received a related benefit from anyone**

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- **A receipt can be issued where the advantage received by the donor (less any token consideration based upon the "*de minimis* threshold" of the lesser of 10% of the value of the gift and $75.00) does not exceed 80% of the value of the gift.**
- **For example, the ticket price for a table of 8 at a fundraising dinner is $2,000.00, the fair market value of the dinner is $800.00, the value of complimentary items; i.e., the door prizes and table gifts is $300.00**

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| | | |
|---|---|---|
| **Total price for a table of 8** | | **$2000.00** |
| **Less:** | | |
| **- value of dinner** | **$800.00** | |
| **- complimentary items** | **<u>$300.00</u>** | |
| **(complimentary items exceed the lesser of 10% of $2000.00 or $75.00)** | | |
| **Total value of advantage received by the donor** | | **<u>$1,100.00</u>** |
| **Eligible amount of charitable receipt** | | **<u>$ 900.00</u>** |

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- **Split receipting at auctions**
  - **Generally, since the bid value at an auction is considered to be the fair market value, no charitable receipt can be issued for an auctioned item**
  - **However, when the value of an item can be clearly determined and is disclosed to all bidders in advance, the eligible amount for receipting would be the difference between the amount bid and the posted value**
  - **Where donative intent is established (i.e. in instances where the posted value of the item is not more than 80% of the accepted bid), a receipt may be issued for the eligible amount**

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- **Purchases of service at auctions**
  - **Where a purchased service has an established fair market value that has been identified to all bidders at the auction before the opening bid, a receipt can be issued to the purchaser for the "eligible amount" where donative intent exists**
  - **The eligible amount for the value of the service would be the difference between the amount paid and the amount of the advantage**
  - **See Registered Charity Newsletter No. 17 at http://www.ccra-adrc.gc.ca/E/pub/tg/charitiesnews-17/news17-e.html for other examples of split receipting**

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**3. Charitable Annuities:**

- **CRA indicated in Technical News No. 26 in December 2002 that the previous administrative position with regard to charitable annuities has no basis in law and can not be continued as a consequence of the amendment to subsection 248(33) of the *Income Tax Act***
- **Instead, a new administrative policy has been proposed which provides for a charitable receipt based on the difference between the cost of the annuity and the gift, rather than the difference between the anticipated annuity payments and the amount of the gift**

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**Facts:**

- **A donor makes a $100,000 contribution to a charitable organization**
- **The donor's life expectancy is 8 years (and the donor lives 8 years)**
- **The donor is to be provided annuity payments of $10,000 per year (total of $80,000)**
- **The cost of the annuity to provide the $80,000 payment over 8 years is $50,000**

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| **Former tax treatment under IT-111R2** | **Proposed tax treatment under Technical News No. 26** |
|---|---|
| • **the donor receives a tax receipt of $20,000 for the year of donation, being the amount of $100,000 in excess of the annuity payments of $80,000** | • **the donor receives a tax receipt of $50,000 for the year of donation, being the amount of $100,000 in excess of the $50,000 cost to provide the annuity** |
| • **All of the $80,000 annuity payments are tax free** | • **$30,000 of the $80,000 annuity payments will be included as income of the donor over 8 years, with the balance of the $50,000 to be tax free** |

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- **However, CRA indicated that the administrative policy set out in IT-111R2 will continue to apply to annuities that were issued prior to December 21, 2002.**
- **The expectation of CRA that, notwithstanding the withdrawal of this administrative policy, "charitable annuities are likely to continue as a means of fund raising, and may well be more advantageous to the donor" remains to be seen**

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**4. The Evolving Shutdown of Tax Shelter Donation Programs**

**Definition of Tax Shelter:**

- **A tax shelter is defined under the *Income Tax Act* as any property for which a promotion represents that an investor can claim deductions or credits which equal or exceed the actual amount of the investment within four years of its purchase**
- **The definition of tax shelter was amended in the February 2003 Budget to include tax credits on charitable donations and limited recourse debt**
- **This meant that tax shelter donation programs with promises of net return on investments were required to be registered as tax shelters**

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**Description of Tax Shelter Donation Program:**

- **The potential misuse of tax shelter donation programs continued to be scrutinized by CRA and was not limited to only "art flips"**
- **The position of CRA was set out in a CRA Fact Sheet entitled "Art-Donation Schemes or 'Art-Flipping'". The mechanism commonly utilized in these schemes is explained as follows:**
  - **Step 1: A promoter gives a person the opportunity to purchase one or more works of art or another item of speculative value at a relatively low price and works with the person in donating the items to a Canadian registered charity**

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  - **Step 2: The person donates the art or other item and receives a tax receipt from the charity that is based on an appraisal arranged by the promoter that is substantially higher than fair market value**
  - **Step 3: When the person claims the receipt on his or her next tax return, it generates a tax saving that is higher than the amount paid**
- **These donation programs turn on the fact that the item in question is purchased at a substantially lower price than its much higher fair market value, and that a donation receipt is issued by a registered charity for the fair market value when the item is donated to it**

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**Warnings By CRA:**

- **CRA provided warnings to charities considering becoming involved in donation tax shelters**
  - **CRA's Fact Sheet entitled "Canada Customs and Revenue Agency Reminds Investors of Risks Associated with Tax Shelters" stated that registration as a tax shelter "does not indicate that the CRA guarantees an investment or authorizes any resulting tax benefits" and that "CRA uses this identification number later to identify unacceptable tax avoidance arrangements"**

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- **CRA's Fact Sheet concerning Art-Donation Schemes or 'Art-Flipping' indicated that third party penalty can include charities that receive the donation if "it knows – or if it can reasonably be expected to have known – that the appraised value were incorrect"**

**December 2003 and February 2004 Amendments:**

- **The December 5, 2003 draft amendments to the *Income Tax Act* are attempting to shut down tax shelter donation programs by severely restricting the tax benefits from donations made under tax shelter donation arrangements**

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**New Deeming Provision:**

- **The proposed amendment deems the fair market value of property donated for the purpose of issuing charitable receipts to be the lesser of (i) the fair market value of the property and (ii) the cost (or the adjusted cost base where applicable) of the property to the tax-payer immediately before the gift is made in the following three situations:**

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1) **If the tax-payer acquires the property through a “gifting arrangement” as defined in section 237.1 of the ITA, i.e. where it is represented that the acquisition of the property would generate any combination of tax credits or deduction that in total would equal or exceed the cost of acquiring the property in question, whether or not it was acquired within three years**
2) **If the tax-payer acquired the property less than three years before the gift was made**

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3) **If it was reasonable to conclude that when the tax-payer acquired the property, the tax-payer expected to make a gift of the property, but with the burden being on the donor to prove that the donor did not have an intention to make a gift when the property was acquired**

- **The deeming provision does not apply to inventory, real property situated in Canada, certified cultural property, publicly traded shares and ecological gifts**
- **The deeming provision also does not apply to situations where the gift is made as a consequence of the donor's death**

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- **The proposed December 5, 2003 amendments with regards to gifts of property, if passed, will apply to gifts made on or after December 5, 2003**

**Limited Recourse Debt:**

- **The December 5, 2003 draft amendments also preclude charitable receipts for limited recourse debt in respect of gifting arrangements**
- **Limited recourse debt is a form of tax shelter in which the tax-payer incurs a debt for which recourse is limited and which can reasonably be considered to be related to a charitable gifting arrangement**

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- **Even in situations where the recourse is not limited, the debt may be deemed to be a limited recourse debt unless the arrangement in writing to repay the debt within 10 years and interest is paid annually within 60 days of the debtor's taxation year at not less than CRA prescribed rate**
- **If a gift includes a limited recourse debt, then the amount of the loan would be deducted from the amount of the gift**

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**Substantive Gifts:**

- **The February 2004 Amendments propose the insertion of a new subsection 248(38) that applies to gifts made after that date**
- **Subsection 248(38) is intended to prevent a donor from avoiding the application of the Deeming Provision by disposing of property to a charity and then donating the proceeds of disposition, rather than the donor donating the property directly to the charity**
- **The property disposed of by the donor is referred to as "substantive gift" and only applies to capital property and eligible capital property not already exempted under subsection 248(38)**

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- **When a person disposes of property to a charity and donates the proceeds of disposition to either that charity or to another charity that does not deal at arm's length with the charity that purchased the property from the donor, then the property is referred to as a "substantive gift"**
- **Under those situations, the Deeming Provision in subsection 248(35) would apply and the fair market value is "deemed" to be the lesser of the fair market value of the substantive gift and the cost, or if the substantive gift is capital property of the tax-payer the adjusted cost base, of the substantive gift to the tax-payer immediately before disposition**

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**Anti-Avoidance Rule:**

- **In addition to the deeming provision, the December 2003 amendments introduced an anti-avoidance rule in subsection 248 (37) that if one of the reasons for a series of transactions that includes a disposition or acquisition of property is to increase the amount of the FMV of the gift, then the cost of the property for receipting shall be deemed to be the lowest cost to the donor to acquire the property in question or "an identical property" at any time**

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**Practical Implications**:

- **Charities will be required to inquire of donors of gift in kind when the property donated was acquired by the donors. Where possible, a written confirmation should be obtained from the donors to evidence the date of acquisition**
- **If the deeming provision applies, then the charity will need to inquire of the donor to determine the amount of the ACB of the gifted property, if applicable**
- **Charities may be required to inquire of donors of gifts in kind to determine whether the donors had an expectation to make a gift at the time when the donor acquired the property**

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- **Charities receiving gifts of private shares will need to determine if the shares were acquired within three years prior to the making of the gift or whether such shares had been exchanged for another class of shares i.e. in an estate freeze, either within three years or for the purpose of making a gift**
- **The proposed amendments in relation to limited recourse debt, if passed, will apply to gifts made on or after February 19, 2003**

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## Utilizing Ten Year Gifts in Charitable Fund Raising

- Need to document ten year gifts
- Expenditure of income by foundations and the 3.5% disbursement quota (currently 4.5%)
- Consequences of expending capital prior to expiry of ten years
- Expenditure of ten year gifts after expiry of ten years
- Managing ten year gifts
  - Keep the ten year gifts in a separate account

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  - This would help to accomplish the following
    - Keep track of original capital and capital gain
    - Less chance that capital would be expended
    - Different investment powers could apply if necessary
- Problems in transfer of ten year gift to foundations now rectified by the 2004 Budget
- Problems in transfer of ten year and other long term gifts from private foundations to public foundations now rectified by the 2004 Budget

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## Conditional Gifts

- What is the nature of a conditional gift?
  - A conditional gift involves the charity becoming the beneficial owner of the gift subject to being defeated by a condition
  - With a special purpose charitable trust, the charity never becomes the beneficial owner of the gift but instead holds it in trust
- Receipting conditional gifts
  - Condition precedent gifts can not be receipted
  - Condition subsequent gifts may be receiptable:
    - Reversion to donor precludes receipting
    - Reversion to another charity will likely be receiptable

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