

## CHARITABLE TAX SHELTER BULLETIN

February 2004

### “IF IT SEEMS TOO GOOD TO BE TRUE...”

#### DEPARTMENT OF FINANCE RELEASES NEW LEGISLATION RESTRICTING CHARITABLE DONATION ARRANGEMENTS

As New Year's celebrations become distant memories, many people will begin turning their minds to the types of charitable contributions they intend to make over the coming year. In surveying the wide range of worthy causes, most Canadians have likely come across at least one charitable giving arrangement that purports to offer tax credits well in excess of the “out of pocket” cost of the required donation.

In recent years, the Canada Revenue Agency (the “CRA”) has targeted many of these arrangements and, in November, 2003, went so far as to release a special “fact sheet” warning taxpayers of the perils associated with “abusive” or “inappropriate” charitable tax-shelter schemes. Yet, despite the aggressive actions of the CRA and several legislative initiatives by the Department of Finance, a number of “cash-positive” donation programs continued to emerge.

On December 5, 2003, the Department of Finance released a broad set of legislative proposals (the “**Proposed Donation Rules**”) that are intended to discourage (if not completely eliminate) the use of so-called “buy low, donate high” arrangements. In addition, the legislative proposals introduce previously announced amendments, including those relating to charitable giving arrangements that use limited recourse debt.

Although the Proposed Donation Rules have yet to be enacted, it is expected that they will be adopted by Parliament largely in their current form. Assuming this is the case, the new rules restricting “buy low, donate high” arrangements will generally apply to any such transactions concluded after 6:00 p.m. EST on December 5, 2003. Other provisions in the new rules may apply to transactions completed as early as December 21, 2002.

This bulletin briefly describes some of the charitable giving arrangements targeted by the Proposed Donation Rules and how the new rules eliminate the benefits associated with these arrangements.

#### “BUY LOW, DONATE HIGH” ARRANGEMENTS

In the months preceding the release of the Proposed Donation Rules, the print media was awash with stories of offerings purporting to allow taxpayers to purchase certain products through “wholesale” channels and then donate their purchases to a charity and receive a tax receipt for an amount well in excess of the purchase price. The viability of these arrangements was predicated on the assumption that the “wholesale” price at which the donated property was “purchased” by participants was less than the “fair market value” of the donated products (i.e., the amount of the charitable donation). In computing the fair market value of the donation and, by extension, the tax credit to be received by the taxpayer, the promoters of these arrangements often claimed that “fair market value” should be determined based on how much the donated property would cost in the Canadian retail marketplace.

For example, some of these recent offerings involved the purchase of basic foodstuffs from an international agency at a wholesale cost, followed by the donation of the “purchased” items to a qualified charity. The promoters of these arrangements claimed that, for Canadian income tax purposes, the “fair market value” of the donated products was the amount that a third party would pay for them at a local Canadian retailer, rather than the amount paid to the foreign supplier of the goods. Thus, in our example, if it cost \$3,000 to purchase the donated foodstuffs at a local Canadian

grocery store, but only \$500 to acquire them from the foreign supplier, the taxpayer would claim a tax credit of up to \$1450 (based on a \$3,000 donation amount), despite having only contributed \$500 of his or her own money to the arrangement. Understandably, the CRA has generally taken a sceptical view of these valuation methods and, in a number of cases, has denied the tax credits claimed by taxpayers who have participated in these types of arrangements.

Despite the CRA's forceful and, in many cases, successful reassessment initiatives, the Department of Finance evidently felt that explicit legislation was required to pre-empt the proliferation of "buy low, donate high" charitable structures and, in so doing, spare unsuspecting taxpayers from future grief. Assuming the Proposed Donation Rules are enacted in their current form, the value of donations of property made after 6:00 p.m. EST on December 5, 2003, will, for charitable tax credit purposes, generally be deemed to be the *lesser* of the fair market value of the property donated and the cost of the property to the donating taxpayer (the "**Valuation Rule**"). Subject to the exclusions noted below, the Valuation Rule will apply where a donated property is acquired by a taxpayer: (i) under a "gifting arrangement", (ii) less than three years before the date of the donation; or (iii) in circumstances where it is reasonable to conclude that, at the time the donated property was acquired, the taxpayer expected to donate it to a qualified charity. Limited types of property are excluded from the ambit of the new rules, including inventory, real property situated in Canada, and shares listed on a prescribed stock exchange. Presumably, these exclusions have been introduced because these types of property either lend themselves to objective, readily ascertainable valuations or, in the case of inventory, the donation of the property will generate income inclusions that will fully offset any potential tax benefits.

#### **LIMITED RECOURSE DEBT ARRANGEMENTS**

Another recently favoured offering of tax shelter promoters involved the use of limited recourse debt to fund charitable donations. In many cases, the limited recourse debt on which the charitable arrangements were based would either never be repaid by the donating taxpayer or, more commonly, would not be repaid until many years into the future (thereby creating a long-term tax deferral). The Proposed Donation Rules address these arrangements by reducing the value of any charitable donation that is eligible for a charitable tax credit by the amount of any limited recourse debt associated with the donation. While the rules generally allow for the recovery of any denied donation amounts in subsequent taxation years, to the extent that the limited recourse debt in question is actually repaid, any deferral advantages associated with arrangements utilizing limited recourse debt appear to have been largely eliminated.

It is important to recognize that many of the new rules relating to the use of limited recourse debt stem from announcements made in the 2003 Federal Budget and, therefore, will ultimately have legislative effect retroactive to February 19, 2003.

#### **"ADVANTAGES" RECEIVED IN EXCHANGE FOR CHARITABLE DONATIONS**

The receipt of goods, services or other benefits in conjunction with a donation to a qualified charity has traditionally given rise to concerns about whether these donations are eligible for charitable tax credits. In order to receive a charitable tax credit, a donation must generally constitute a "gift". Yet, since a "gift" has generally been interpreted as the transfer of property without the prospect of consideration in return, it has often been feared that the receipt of any form of benefit would jeopardize the eligibility of a donation for a charitable tax credit.

The Proposed Donation Rules, building on amendments originally released on December 20, 2002, include special "safe harbour" rules that address this concern. Specifically, a transfer of property to a qualified charity will be treated as a "gift" for charitable tax credit purposes, provided the amount of any "advantage" (as defined in the new rules) received by the donor (and certain other persons connected with the donor) does not exceed 80% of the fair market value of the transferred property or where the donor of property establishes, to the satisfaction of the Minister, that the transfer was made with the intention of making a gift to the charity.

Nevertheless, the Proposed Donation Rules also provide that the amount of any charitable donation will be reduced by the amount of the “advantage” received by a donor in connection with the donation. The term “advantage” is broadly defined in the Proposed Donation Rules to include any property, service, compensation or other benefit, whether immediate or future, absolute or contingent, that is received in consideration or gratitude for a gift or that is in any way related to the gift. For example, where a taxpayer receives a dinner in connection with a charitable fund raising event, the fair market value of the dinner will be deducted from the amount paid by the taxpayer when computing the portion of the amount eligible for a charitable tax credit.

## CONCLUSIONS

As noted above, the provisions contained in the Proposed Donation Rules have varying effective dates, spanning from as early as December 21, 2002 to as late as December 5, 2003. Accordingly, whether one or more of the new rules apply to a particular arrangement will have to be determined on a case-by-case basis. However, taxpayers would be ill advised to assume that donations made before the Proposed Donation Rules came into effect will not be challenged by the CRA. The CRA has reassessed, and will continue to reassess, many of the arrangements now covered by the Proposed Donation Rules, either on valuation grounds or on the basis of the existing provisions of the *Income Tax Act*. Taxpayers who have participated in the types of arrangements covered by the Proposed Donation Rules would be well advised to review their past donations and seek professional advice with a view to determining the scope of their reassessment risk. Similarly, charitable organizations that have previously been associated with such arrangements should seek counsel to determine their exposure. Finally, despite the release of the Proposed Donation Rules, private promoters continue to market aggressive charitable donation arrangements. Taxpayers and charitable organizations should exercise great caution and obtain independent legal advice before participating in any such arrangements.

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McMillan Binch LLP regularly advises both charitable organizations and potential donors on the tax implications of a wide array of charitable arrangements. If you have questions about the Proposed Donation Rules, or the taxable status of a past donation made to a registered charity, one of the members of our Charities & Not-for-Profit Entities Group listed below would be pleased to assist you.

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*The foregoing provides only an overview. Readers are cautioned against making any decisions based on this material alone. Rather, a qualified lawyer should be consulted.*

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