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Advice for **Advisors** is for professionals working in the financial planning, insurance, estate and tax accounting, Wills and estates law, investment planning and wealth management fields. This publication, distributed three times/year, provides authoritative information on the topic of philanthropy and highlights The Calgary Foundation's expertise in charitable and planned giving.

in this issue...

Charity Tax Shelters

- ▶ **What are charity tax shelters?** 2
- ▶ **What types of charity tax shelters have CRA disallowed?** 3
- ▶ **Buy-low donate-high** 4
- ▶ **Gifting trust arrangements** 5
- ▶ **Leveraged charitable donation** 6
- ▶ **Cautionary tale for advisors and charities** 7
- ▶ **Further reading** 8

Charity Tax Shelters

by **J. Oosterhuis**, in collaboration with **L. Pirbhai**

We introduce this topic with some trepidation – for fear that some readers may assume that we have been involved in a disallowed charity tax shelter! Please be assured that The Calgary Foundation has not been involved with, even in a peripheral way, a disallowed charity tax shelter.

However, we take our mandate to educate the public on issues of relevance to charities and their advisors very seriously. Charity tax shelters have proliferated in the last 10 years and many have been lately disallowed by the Canada Revenue Agency (CRA) – it is important that we introduce and discuss how these disallowed charity tax shelters operate and what steps the government has taken to limit the use of charity tax shelters in the future.

What are charity tax shelters?

In the past several years a number of tax shelters, specifically ‘charity tax shelters’, have been investigated and disallowed by Canada Revenue Agency (CRA). ‘Charity tax shelter’ is odd phrasing – when thinking of charities, most Canadians do not think of funds directed to charity as one of their of a ‘tax shelter’ options. For most Canadians, the phrase ‘tax shelter’ bring to mind RRSPs, RESPs, private residences, and, more recently, TFSAs. Each of these allows you, to a greater or lesser extent, to shelter investment income or increases in investment value from being taxed.

In addition, specific tax shelters are allowed by the government to encourage investment in high-risk investments. Less well known tax shelters are Multiple Unit Residential Buildings (MURBs), popular in the 1970’s, that allowed tax deductions for annual depreciation against other income and Labour-Sponsored Investment Funds (LSIFs), introduced in the 1990’s,

that allowed tax credits of 30% or more for investment in risky start-up ventures. More recently, the Canadian government has allowed companies to ‘flow through’ tax expenses associated with their Canadian exploration activities to investors, who can deduct the expenses in calculating their own taxable income, making a risky investment more attractive.

Yet a quick Google search for the term ‘charity tax shelter’ leads you to a number of articles written since 2007 about charity tax shelters that have been disallowed by Canada Revenue Agency (CRA). Between 2003 and 2009, CRA estimates that approximately 172,000 Canadians became involved in tax shelters involving claims of inflated receipts totalling more than \$5.4 billion.¹ When considering Canada’s, and especially Alberta’s, generous allowable tax deduction for donations to charity, that could equal more than \$2.5 billion in lost tax revenue.

A number of taxpayers are caught by surprise when their returns are audited. CRA may initially allow a tax credit for amounts donated, but they have seven years to audit and re-assess a taxpayer’s returns. Although CRA appears to be moving at a snail’s pace, they are reviewing charitable tax shelters through ongoing audit investigations and are disallowing a large portion of the receipted value of charitable donations under disallowed tax shelters. Further, if CRA decides that a taxpayer knowingly falsified information on their return, there is no time limit for them to disallow a claim and they have the power to charge penalties against both the taxpayer and their tax preparer. Due to CRA’s review and decision to disallow a number of charity tax shelters, CRA estimates that donations to these types of tax shelters have fallen to \$284 million in 2009.²

1 Information from Imagine Canada site: “Statistics Canada Releases Most Recent Charitable Donor Stats”, December 6, 2010 in *Sector News* by dlasby; <http://blog.imaginecanada.ca/2010/12/06/charitable-donations-2009/>

2 *Ibid*

What types of charity tax shelters have CRA disallowed?

A review of recent Tax Court of Canada (TCC) case law indicates there are a number of varied tax shelters that have been disallowed by CRA. TCC cases are appeals from CRA decisions to re-assess a taxpayer's returns and therefore The Queen, in this case CRA, is the respondent.

The government relied on the decisions of the tax court in drafting Bill C-10³. Bill C-10 amends several sections of the In-

come Tax Act (ITA) to limit the scope of claimable charitable donation tax credits. It is important to remember that although Bill C-10 has not been ratified into legislation, CRA has an administrative practice of asking taxpayers to file returns with reference to pending legislation.

The disallowed tax shelters can broadly be divided into three categories. The following chart illustrates the salient attributes

of each of the three types of disallowed tax shelters with a variant listed for gifting trust arrangements. Further, the chart highlights the CRA re-assessments based on audits of taxpayers involved in the disallowed charity tax shelters, decisions of the Tax Court of Canada on appeals by the effected taxpayers, and legislation/pending legislation undertaken by the government to limit the proliferation of charity tax shelters.

Disallowed Charity Tax Shelters	Salient attributes	Results of CRA audits/re-assessments, legal judgements and Bill C-10
Buy-low donate-high	<ul style="list-style-type: none"> • Taxpayer purchases property at low cost through promoter • Appraisal(s) in place for a value more than double the purchase price • Donation of property to a registered charity • Taxpayer receives a donation receipt for the appraisal value 	<ul style="list-style-type: none"> • Court decision that 'deemed' fair market value (fmv) of property to be the lower of fmv and adjusted cost base (ACB) • CRA assesses penalties against taxpayer for false statements or omissions – not upheld by the court • Bill C-10 redefines 'personal use property' to exclude items received through a 'gifting arrangement' or items purchased within three years of donation • CRA begins audits of charities that are involved with charity tax shelter
Gifting Trust Arrangements	<ul style="list-style-type: none"> • Taxpayer makes a donation to a charity through a promoter • Taxpayer becomes a beneficiary of an off-shore trust • Taxpayer's donation is selected for a top-up of up to 4x original donation by the trust • Taxpayer receives a donation receipt for the original donation plus the top-up • Variant of tax shelter arrangements is where taxpayer makes a large donation and receives a kickback up to 75% of the value of the donation 	<ul style="list-style-type: none"> • CRA disallows the full amount of the donation, including portion that the taxpayer is out of pocket • Courts rely on common law definition of 'gift' to exclude gifts where donor receives a significant benefit in return for the gift • Courts find an exception where the taxpayer had no 'expectation' of being selected for top-up, taxpayer allowed to claim out of pocket donation amount • Bill C-10 redefines 'gift' to exclude gifts where taxpayer receives an 'advantage' greater than 80% of donation
Leveraged Donations	<ul style="list-style-type: none"> • Taxpayer borrows funds through promoter and donates out of pocket plus loan amount • Promoter offers a no-recourse loan or taxpayer makes deposit against loan that is insured to grow to cover loan • Taxpayer receives a donation receipt for out of pocket plus loan amount 	<ul style="list-style-type: none"> • CRA and the courts disallow the full amount of the donation, court states that the cash portion of donation is inseparable from loan portion of donation • Legislation is introduced in 2003 to require that charity tax shelters that promise deductions of equal or greater than donation within 4 years must be registered and list registration # on donation receipts

³ A full text copy of Bill C-10 can be found at <http://www.parl.gc.ca/Default.aspx?Language=E> by clicking on the right hand box titled "Bills", then scrolling to and selecting "C-10" on the next page

Buy-low donate-high

Firstly, 'buy-low donate-high' tax shelters where the scheme promoter arranges for the donor to purchase property for a low price and donate the same. The promoter has usually pre-arranged an appraisal of the property that values it at a high cost and the donor receives a donation receipt for the purported fair market value at the appraisal value. Frequently the property is also claimed as personal use property to avoid capital gains tax on the difference between purchase price and appraisal value. The tax court decision in *Klotz v The Queen*⁴ is an excellent example of this type of disallowed tax shelter.

Klotz was one of the first cases to be decided involving 'buy low, donate high' schemes, a tax shelter frequently promoted throughout the 90's. The tax shelter involved the purchase and charitable donation of 'personal use property'—property valued at less than \$1000. Mr. Klotz purchased 250 original prints for \$300 each, or \$75,000 in total, on December 28, 1999. Two days later, December 30, 1999, he donated the same to an educational institution. Based on the lower of two appraisals, the educational institution issued him a tax receipt for \$258,400 for the original prints and Mr. Klotz claimed the same in his personal tax credits filing of 1999.

CRA disallowed the claim for \$258,400 on two grounds;

- a) The fair market value of each of the prints was at most \$300, the amount paid by Mr. Klotz, and
- b) The prints were not personal use property and therefore should attract capital gains on disposition.

Although the ITA allows fair market value be determined through appraisals, the court found that the best evidence of fair market value of the prints was the price at which the prints were bought, in this case \$300 each. But the court decided that the art prints were 'personal use property' and should not attract capital gains.

The decision in *Klotz* was appealed to the Federal Court of Appeal, where it was dismissed.⁵ *Klotz* has been appealed to the Supreme Court of Canada and is awaiting a hearing.

The decision in *Klotz* informed the drafting of Bill C-10. Bill C-10 states the 'deemed fair market value' of donated property is the lesser of the fair market value and the cost (or ACB) of the property immediately before the donation.

Where

- fair market value = *fmv*
- cost to purchaser = adjusted cost base = ACB

Then if

- *fmv* > ACB, ACB is the 'deemed fair market value' for donation receipting

or

- *fmv* < ACB, *fmv* is the 'deemed fair market value' for donation receipting.

Happily, this 'deemed fair market value' is only applied in specific circumstances, it does not include shares listed on prescribed stock exchange, bequests through a will, and certain corporate or individual rollover transactions for the purpose of donating shares.⁶

In 2003, the ITA definition of 'personal use property' was revised to be more strictly defined. Under the new provisions, these prints would no longer be considered personal use property and would attract capital gains on the difference between value for donation purposes and ACB.⁷

⁴ *Klotz v The Queen* 2004 TCC 147, note: the full text of this tax court judgement is freely available at <http://decision.tcc-cci.gc.ca/en/2004/2004tcc147/2004tcc147.html>; you can search cases by year, name, or by subject

⁵ *Klotz v Canada* 2005 FCA 158, full text of the decision can be found on the Federal Court of Appeal site at <http://decisions.fca-caf.gc.ca/en/2005/2005fca158/2005fca158.html>

⁶ Bill C-10, subsection 187(37)

⁷ See subsection 46(1) and section 54 of the current ITA for the revisions

Gifting trust arrangements

Secondly, 'gifting trust arrangement' tax shelters where a donor who is inclined to charitable giving becomes the beneficiary of a Canadian resident trust and property from the trust is donated on behalf of the beneficiary/donor. The donor receives a donation receipt for his or her actual donation and the trust property donated. This is the scenario described in *Doubinin v The Queen*⁸, with a variant as laid out in *McPherson v The Queen*⁹.

McPherson dealt with whether a donor can claim the full amount of his donation if a substantial portion of the donation was returned as a 'gift' to the donor. In 1996 a charity tax shelter operated with the donor contributing a certain amount and shortly thereafter received an "educational gift" equal to 75% of the donor's contribution. Although Mr. McPherson maintained that he did not receive an "educational gift" or kickback and the respondent could not directly show that Mr. McPherson had received the kickback, the court found that, on the balance of probabilities, Mr. McPherson did receive the kickback.

Of note in the *McPherson* case is that the court held that there was no 'gift'. The entire gift, including the actual amount Mr. McPherson was out of pocket, was disallowed.

Two years prior to the decision in *McPherson*, the court allowed the taxpayer, Mr. Doubinin, in *Doubinin v The Queen* to claim a tax credit for his actual donation amount. The circumstances of the case were slightly different than those in *McPherson* – Mr. Doubinin was advised that his donation may be selected to be matched by up to four times his original donation and, if selected, he would receive a donation receipt equal to four times his donation. Mr. Doubinin donated \$6,887 and received a donation receipt for \$27,000. In contrast to the decision in *McPherson*, the court found that Mr. Doubinin had no "expectation" of receiving the top-up.

Bill C-10 was drafted to reduce the allowable 'advantage' a taxpayer could gain from a donation. The amount of the 'advantage' is calculated as the total value of

all property, services, compensation, use or other benefits to which the donor, or a related person, has received or obtained or is entitled to receive as partial consideration of or in gratitude of the gift. The amount of 'advantage' is used to calculate the 'eligible amount' as follows:

Where

- *fmv* is the lesser of appraisal value and ACB,
- the amount of 'advantage' > 80% of the *fmv*, and,
- the 'eligible amount' = the amount the taxpayer can claim as tax credit

Then

- *fmv* – the amount of the 'advantage' = the 'eligible amount'.

Happily, the tax credits that a taxpayer receives for donating to registered charities is not considered an 'advantage'.

⁸ *Doubinin v The Queen* 2004 TCC 438, full text of decision available at <http://decision.tcc-cci.gc.ca/en/2004/2004tcc438/2004tcc438.html>

⁹ *McPherson v The Queen* 2006 TCC 648, full text of decision available at <http://decision.tcc-cci.gc.ca/en/2006/2006tcc648/2006tcc648.html>

Leveraged charitable donation

Lastly, 'leveraged charitable donation' tax shelters, where a taxpayer borrows a funds through the shelter promoter and donates the loan and additional cash to a charity. The loan arrangements are generous, they may be based on an initial deposit that is expected to grow to cover the full loan over a set time period and be insured against the event that the initial deposit does not grow sufficiently. The donor receives a donation receipt for the full amount of the donation. This scenario is the subject of the *Marechaux v The Queen*¹⁰ decision.

In *Marechaux*, the tax shelter promoter sought donors who would pledge to donate a minimum of \$100,000 on the basis that the donors would be responsible personally to contribute \$30,000 of that amount, and an interest-free loan would be provided to them in connection with the program in the amount of \$80,000.

Of the \$80,000 loan, \$70,000 formed part of the gift and \$10,000 was used to pay a fee, security deposit, and insurance policy that rounded out the tax shelter arrangements. The security deposit was intended to grow within 20 years to cover the \$80,000 loan and the insurance policy to cover any shortfall in the growth of the security deposit.

The court found that the donor received a significant benefit, an \$80,000 loan on generous repayment terms, in exchange for his gift and therefore the gift did not meet the common law concept of a 'gift'. At common law, a 'gift' is defined as a "voluntary transfer of property owned by a donor to a donee, in return for which no benefit or consideration flows to the donor."¹¹ The entire gift was not eligible for charitable donation tax treatment.

The decision in *Marechaux* was appealed to the Federal Court of Appeal, where it was dismissed, and then to the Supreme Court of Canada, where it was again dismissed.¹² The decision of the Tax Court of Canada stands and is persuasive precedent in deciding similar situations that come before the courts.

The above mentioned cases were instrumental in the government's decision to limit the use of charitable tax shelters. In 2003, the ITA was amended to include the requirement that any tax shelter promoted to provide deductions equal to or greater than the purchaser's net cost of the property must be registered with CRA and be given an identification number.¹³ However, CRA is warning taxpayers that a tax shelter identification number does not indicate that CRA guarantees an investment or authorizes any resulting tax benefit.

10 *Marechaux v The Queen* 2009 TCC 587, full text of decision available at <http://decision.tcc-cci.gc.ca/en/2009/2009tcc587/2009tcc587.html>

11 Wording is attributed to a 1974 case, *The Queen v Zandstra*, and quoted in *Marechaux*

12 *Marechaux v Canada* 2010 FCA 287, full text version at <http://decisions.fca-caf.gc.ca/en/2010/2010fca287/2010fca287.html> and *Marechaux v The Queen* 2011 SCC 34073, notation at http://scc.lexum.org/en/news_release/2011/11-06-09.3/11-06-09.3.html

13 For further reading, see subsection 237.1(1) of the ITA

Cautionary tale for advisors and charities

CRA recognizes that very few taxpayers and advisors are involved in supporting or promoting disallowed charity tax shelters and that the same individuals/organizations are often repeatedly found to be involved in new charity tax shelters that are later disallowed by CRA. To dissuade these individuals/organizations from continuing to promote or participate in novel charity tax shelters, CRA is seeking to impose penalties on taxpayers and/or their tax planners and tax preparers where it is deemed that they knowingly or ought to have known that they provided false information to or omitted to provide information to CRA.

The few charities that were involved in charity tax shelters were often created by the tax shelter promoters or were managed by unsophisticated boards that un-

wittingly accepted the advice of a trusted tax advisor that promoted or was linked to a charity tax shelter. CRA is assessing penalties against and/or de-registering the few charities involved in disallowed charity tax shelters for incorrect receipts, false receipts and failing to maintain and/or provide accounting books and records. Penalties can range from 5% to 125% of the donation receipts issued. In addition, CRA can suspend a charity's donation receipting privilege and, in the most egregious circumstances, can de-register a charity.¹⁴

In addition, participation in any of the three charity tax shelters described above could result in the charity not being able to meet its disbursement quota. CRA can revoke charity status for failure to meet disbursement quota.

CRA's Charities Directorate is responsible for providing education and tools for charities to promote accuracy in charity tax filings. The Charities Directorate has been active in disseminating information about disallowed charity tax shelters. A secondary responsibility of the Charities Directorate is audit and compliance issues involving charities. The Charities Directorate notes that charity tax shelters cannot operate without a willing charity or registered amateur athletic association. The Charities Directorate's goal is to dissuade these donation receipt issuing organizations from becoming involved in charity tax shelters that are later disallowed and by extension eliminating opportunities for promoters to create charity tax shelters that will later be disallowed.¹⁵

¹⁴ For further information see the ITA, subsection 188.1(7) and 188.1(9)

¹⁵ Volunteer Lawyers Service, <http://www.volunteerlawyers.org/news/article.204045>

Further reading

The following list is by no means a comprehensive list of resources, but it should start you on a path to discovering more.

Government sites

<http://www.cra-arc.gc.ca/nwsrm/lrts/> – CRA website that lists Alerts, searchable by year

<http://www.cra-arc.gc.ca/gncy/lrt/menu-eng.html> – CRA website that lists Tax Alerts and other information bulletins of interest to the taxpayers & advisors

<http://www.cra-arc.gc.ca/nwsrm/rlss/> – CRA news releases, searchable by year of publication

“Report on abuse of Charities for Money-Laundering and Tax Evasion”, published by the Centre for Tax Policy and Administration, a copy can be found at www.oecd.org/dataoecd/30/20/42232037.pdf

<http://decision.tcc-cci.gc.ca/en/> – Tax Court of Canada judgements, searchable by year, subject and case name

<http://www.cra-arc.gc.ca/chrts-gvng/chrts/bt/menu-eng.html> – everything you want to know about the Charities Directorate

www.cra-arc.gc.ca/charities/ – other CRA resources for charities

<http://www.taxtips.ca/personaltax/taxshelterdonations.htm>

<http://decisions.fca-caf.gc.ca/en/index.html> – Federal Court of Appeal decisions

<http://decisions.fct-cf.gc.ca/en/index.html> – Federal Court decisions

<http://scc.lexum.org/en/index.html> – Supreme Court of Canada decisions

Charities advising charities

<http://library.imaginecanada.ca/>

<http://www.cfc-fcc.ca/home.cfm>

<http://www.volunteerlawyers.org/news/> – searchable database of articles, including several about tax shelters

<http://www.cagp-acpdp.org/> – Canadian Association of Gift Planners has a section “In the News”

Newspaper articles/tv broadcasts

<http://license.icopyright.net/user/viewFreeUse.act?fuid=MTM3NDE2OTA%3D>

<http://www.thestar.com/News/GTA/article/624338>

<http://www.cbc.ca/news/canada/edmonton/story/2010/04/14/mb-fast-tax-shelter-scheme-manitoba.html>

Articles, papers published by law firms, accounting firms, financial advisor companies, universities

“Fraud in Canadian Nonprofit Organizations as seen through the eyes of Canadian Newspapers, 1998-2008”, by Qiu Chen, Steven Salterio & Pamela Murphy, of Queen’s University, abstract available at www.thephilanthropist.ca/index.php/phil/article/download/511/517

“The Continuing Saga of Charitable Donation Tax Shelters in Canada” by Robert B. Hayhoe and Amanada J. Stacey, both of Miller Thomson LLP, published in *The Exempt Organization Tax Review*, Vol. 61, No.2 at page 159, full text available at http://www.millertomson.com/assets/files/article_attachments/The_Continuing_Saga_of_Charitable_Donation_Tax_Shelters_in_Canada.pdf

<http://www.cch.ca/newsletters/TaxAccounting/May2010/index.htm> – CCH Canadian produces professional information products about regulatory issues in tax, accounting, law, financial planning and human resources

<http://www.canadiancharitylaw.ca/index.php> – a blog by Mark Blumberg, an Ontario lawyer practicing in charity law

<http://www.carters.ca/pub/bulletin/charity/2006/chylb87.htm>

<http://www.millertomson.com/en/publications/newsletters/charities-and-not-for-profit-newsletter> – searchable database of Miller Thomson’s newsletter “Charities and not-for-profit Newsletter”