New Rules for Charitable Giving
by Blake Bromley

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Introduction

In recent years there has been a steady series of significant enhancements in the rules governing charitable giving in Canada. The February 18, 1997 Federal Budget introduced more enhancements but also a significant curtailment of gifts of certain types of property. These curtailments have been strongly resisted by portions of the charitable sector. Finance has listened to some of the complaints and on July 31 issued draft legislation in Release 97-065 which substantially changed many of provisions set out in the February draft legislation. Unfortunately, these amendments also have very many technical and policy problems. The Department of Finance has maintained that many of the technical concerns will be addressed in the legislation introduced into Parliament but will not disclose specific changes. It has also stoutly refused to bend further on the policy issues raised related to gifts of non-qualifying securities and loanbacks. However, it has scheduled a meeting with representatives of the charitable sector the day after this Annual Tax Conference ends and has indicated that changes to the policy issues will be disclosed at that meeting.

Consequently it is almost impossible to write a meaningful paper on the new rules for charitable giving when there is no certainty as to what the new rules will be or even how many of the proposed new rules will survive into legislation. Countless hours of have been committed by tax professionals and members of the charitable sector to try understand and remedy these proposed rules. While professionals have bickered with Department officials, the donors have basically adopted an attitude of refusing to consider any major tax planned gifts until the rules are clarified. As year end approaches, the cost of this uncertainty to the charitable sector is becoming very acute. If, as promised, the legislation is introduced into Parliament in mid-December, there will only be a very short time to analyze the final provisions and determine whether it is reasonable to make a gift prior to December 31, 1997. Very few philanthropists will want to make major commitments in that time frame at that time of year. The cost of the uncertainty surrounding the introduction of these new rules will be very high for the charitable sector.

Changes in the Rules in 1997

The original public reaction to the February 18, 1997 Federal Budget presented by Paul Martin was very positive because almost all of the attention focused on the reduction of the capital gains inclusion when public securities are gifted to charities other than private foundations to 37.5%. Cutting the capital gains
inclusion in half has the effect of increasing the after-tax donation benefit on appreciated capital property by 20% of the capital gain. This valuation is arrived at by simply multiplying the additional 37.5% of unused net donation tax credit by the effective value of the donation tax credit. Assuming a marginal rate of 54% in British Columbia, the amount is 20.25%.

Another way to analyze the impact of the reduction in the rate of capital gains inclusion is that it allows the owner of appreciated capital property to donate all of the tax payable on a capital gain to a public charity if the gain results from a public security and that security is donated en specie prior to any sale. However, to obtain this result the donor must also donate to the same charity the after-tax proceeds which would have been received on a sale. Most donors are delighted to make this donation as they want to benefit the recipient charity.

The second thoughts have come from donors who have private foundations and wonder about the policy and lobbying procedures which achieved this change to the donation rules. Their understanding is that these tax changes resulted from lobbying on behalf of the charitable sector rather than being unilaterally proposed by the Department of Finance. Consequently, their concern is why for the first time in Canada has a charitable donation benefit which has been extended to other registered charities been denied to private foundations. This concern was greatly increased as they studied the Budget documents further and saw the harsh provisions which introduced to penalize the donations of debt and shares in private corporations.

There has been a great deal of concern about the proposed changes to the Income Tax Act rules governing the gifts of shares and debt obligations of private corporations as set out in Resolution 21 of the Notice of Ways and Means accompanying Paul Martin’s February 18, 1997 Federal Budget. I was one of the first to raise the alarm. Three days after the budget, I sent Paul Martin my “Good News — No New Taxes Budget” letter (attached as Appendix 1) which won me no friends at the Department of Finance. This letter used very strident tones to tell them that the proposed 50% tax imposed on charities who received gifts of shares or debt obligations from private Canadian corporations would close down virtually all sophisticated tax planned charitable giving. It seemed that the Department of Finance had taken all the gift planning proposals set out in my paper at last year’s Canadian Tax Foundation Annual Conference and sought to eliminate them with Resolution 21. It would even catch simple cash and bank cheque gifts in certain circumstances.

Resolution 21 also had a 50% penalty tax which would most of the financing involving the new $800 million Foundation for Innovation which was showcased in the Apparently the comments in my letter related to the application of part (b) of Resolution 21 had some impact as those proposals disappeared without a trace in the July 31 amendments.

The February 18 Federal Budget had another significant change which had interesting political implications with regard to the charitable sector. This was Paul Martin’s reduction of Crown gifts tax credit annual income limitation to 75% while increasing the annual income limitation for charitable gifts to 75%. On March 6, 1997 I sent Paul Martin another letter (Appendix 2) discussing how harmful his Budget amendments which created a “level playing field” for all charities were for universities and
hospitals. This letter referred to the proposed amendment which lowered the annual income limitation for Crown gifts to 75%. Many leaders in the charitable sector who do not have access to Crown foundations have actively lobbied the government against this preferred treatment for universities and hospitals. Consequently, there is little political support for the government to change its position on this issue. The Department of Finance has shown no interest in altering its position on this issue.

Neither of those letters evoked a response to me, so on April 2, 1997 I wrote to Jim Peterson, the Chairman of the House of Commons Standing Committee on Finance (Appendix 3) with a “big picture” analysis rather than a technical analysis. It focused on the fact that the legislation in the February 18, 1997 Budget had not created a level playing field for Crown foundations as they were exempted from all of the penalty taxes. This issue was addressed in the July 31 amendments by changing the application of these provisions to “qualified donees” rather than just “registered charities.”

The letter to Jim Peterson also pointed out how the tax advantages flowing from the reduction in capital gains inclusion when donors gave gifts of appreciated securities were effectively clawed back since Section 127.5 added back the resulting exempted capital gain for purposes of alternative minimum tax calculations. This issue was remedied in the July 31 amendments by excluding capital gains arising from gifts of appreciated securities from alternative minimum tax.

The biggest change in the July 31, 1997 amendments (Release 97-065) was that Finance completely abandoned the 50% tax on recipient charities for gifts of shares and debt obligations of private corporations. Instead, it proposed a system of delaying the donor’s recognition of the capital gain and the corresponding charitable donation tax credit until the charity had liquidated the offending property gift. These private company shares and debts are defined as “non-qualifying securities”. If the non-qualifying security is not liquidated within five years, the donor will not be able to claim the donation tax credit and will have to pay tax on the capital gain. Consequently, the July 31 amendments in Release 97-065 acknowledged the technical failure of the provisions of the February 18, 1997 Budget and tried to achieve the same policy objective by a different means.

It is not terribly useful to do a detailed technical analysis of the proposed amendments in Release 97-065 when one knows that there will be significant changes coming forward after this conference but prior to this paper being published in the Conference Report. However, it is necessary to provide an overview of what the legislation intends.

The intent of the legislation is to make it unattractive for donors to give a “non-qualifying security” unless the charity very quickly “monetizes” the security donated. Non-qualifying security is a defined term which includes debt issued by the donor or persons who do not deal at arm’s length with the donor. It also includes a share or any other security in the capital stock of a private corporation which the donor does not deal at arm’s length immediately after that time period.

The proposal is to deem the gift of the non-qualifying security to have not taken place at the time the donation is made for purposes of the donor utilizing a charitable donation tax credit. However, the
donation is a disposition of the security for tax purposes. Therefore, if the non-qualifying security is appreciated property the donor will have triggered a capital gain by making the gift.

The solution proposed is to set up a reserve in new subsection which defers the taxation of a capital gain resulting from a disposition on a non-qualified security for up to sixty months. If the charity disposes of the non-qualifying security for cash or anything other than another non-qualifying security during this time period, the charity issues a charitable donation tax credit to the donor. This would enable the donor to then utilize the donation tax credit for the value received by the charity when it monetized the non-qualified security. This is only available if the monetization takes place within sixty months of the date of the gift. If this monetization does not happen, then the donor would be liable to pay tax on the capital gain once the reserve period was exhausted and would never get a tax credit for the gift of the non-qualifying security.

The problems presented by this legislation are legion and are particularly acute if the gift takes place in a will. There are a variety of situations in my personal experience in which a very complicated estate compounded by litigation where the testamentary charitable bequest was challenged meant that the executors of the estate were under a legal obligation not to monetize the gift within five years. There are also situations where due to changes in the marketplace, the value of assets fall between the time of the gift and the monetization. The value of the charitable donation tax credit will be the lesser of the amount claimed at the disposition of the non-qualifying security and the actual amount received upon monetization.

Consider a situation in which a donor thinks that the shares of the private corporation are worth $1,000 and claims that amount as the proceeds of disposition. If the shares ultimately receive only $900 upon monetization, the donor can only receive a $900 donation tax credit. Consequently, the donor will have a taxable capital gain on the phantom $100 of excess value that he thought the shares were worth at the time of the gift. If the donor guards against this situation by listing the value at only $900 and the charity subsequently monetizes them for $100, the donor will still only get a charitable donation tax credit for $900.

The result is that the donor will be inclined to put conditions on the gift of a non-qualifying security requiring the charity to monetize them as soon as possible. Any such conditions provide very real legal problems as to whether the donation is then a “gift” at law. Revenue Canada has been telling charities for years that it is improper for donors to attach any type of condition related to a buy-back or designated sale of any property donated to charity because that may not be a “gift.” This proposed legislation makes such conditions almost mandatory from the donor’s perspective; but no consideration is being given to the legal problems presented when such conditions are attached. The public policy issues behind the proposed amendments seem to encourage almost instant monetization. There will be certain assets where immediate monetization is not in the best interest of the charity as the asset donated has so much potential to grow in value and pay significant annual returns that it would be prudent to retain the non-qualifying security rather than monetize it.
It is an ironic result of this proposed legislation that the better the value of the non-qualifying security donated the greater are the legal and tax risks which the donor must bear. If a wealthy corporation with impeccable credit credentials gave a charity a promissory note bearing an annual interest rate of ten percent, it better hope that the charity will ignore the best interests of the charity and convert that promissory note into a term deposit at the bank which will only pay six percent. Otherwise, the donor corporation will never get a charitable donation tax deduction.

There are other problems relating to the reserve provisions as they require that “throughout the following taxation year the taxpayer is resident in Canada” if the donor is to claim the reserve. This provision automatically eliminates non-residents who may want to make donations of their Canadian assets to a Canadian charity. Since non-residents almost invariably hold such Canadian assets through a private Canadian corporation, the only assets which a non-resident donor has to give is a non-qualified security, being shares in a private Canadian corporation, which almost certainly have a low cost base and a high degree of appreciated value.

It is impossible to understand how a donor can meet the reserve requirements of being resident in Canada throughout the following taxation year when the donor has died. This is of particular concern where a donor makes a gift of a non-qualifying security shortly before his death rather than in his will. There is also a separate provision in subparagraph 72(1)(c) to deny the reserve for a non-qualified security when there is a donation to charity in the donor’s year of death. This makes planning related to testamentary gifts very difficult.

There are many more technical problems in the provisions relating to ordering of donation tax receipts in subsection 118.1(2.1) and in knowing whether a charity should issue an official donation receipt for a gift of a non-qualifying security which has been received by the charity but has been deemed not to have been made by the Income Tax Act. The prescribed information set out in Regulation 3501 states that the value of the gift should be on the day on which it was received. However, if the proceeds of the monetization of the non-qualified securities are less than the value of the property on the date of the gift, then there is another discrepancy in how charities need to handle these gifts.

**Dividend Tax Credit Calculations**

What the charitable sector needs right now is certainty as to what provisions Finance will enact and their exact wording. Then it will be possible to plan new ways to do sophisticated gift planning rather than simply mourning the passing of last year’s techniques. There are some very real opportunities opened up by raising the annual income limitation for total charitable gifts to 75% of the individual’s income in the year. This is particularly true when the new 75% limitation is applied to dividend income for which the donor receives a dividend tax credit.

Consider the result when the new 75% annual income limit is applied to dividend income for which the donor receives a dividend tax credit. The Act deems the recipient of dividend income to gross up taxable income so that $100 of dividend income is deemed to be $125. The donor can therefore utilize a tax credit of $93.75. However, if the donor has no other taxable income, maximum tax efficiency is
achieved by making a donation of only $67.50 to charity. This will result in the donor paying no tax to Revenue Canada and retaining the remaining $32.50 as tax paid income. The details of this calculation are set out in Case Study # I.

If a taxpayer has charitable tax credit carry forwards from previous years which have not been utilized, then that taxpayer should consider triggering a dividend payment of $100. The taxpayer will retain 100% of the dividend received and pay no tax to Revenue Canada because of the $67.50 donation tax credit carry forward. If the corporation paying the dividend has adequate refundable dividend tax on hand (RDTOH) then the payment of the dividend will result in Revenue Canada remitting $33.33 to the taxpayer’s corporation in addition to the favorable tax results obtained by the taxpayer as an individual.

### Case Study # I

**Tax Position of a Donor Making a Gift of Dividend Income to a Registered Charity**

The following is an illustration of the net position a British Columbia taxpayer who pays tax at the highest marginal rate of 54% would be in if he or she received a taxable dividend of $100, and made a gift to a registered charity of $67.50. The donor can retain the remaining $32.50 without paying any tax.

<table>
<thead>
<tr>
<th>Income</th>
<th>$</th>
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<tbody>
<tr>
<td>Dividend Received</td>
<td>100.00</td>
</tr>
<tr>
<td>Add: 25% Gross-up</td>
<td>25.00</td>
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<tr>
<td>Taxable Dividend</td>
<td>125.00</td>
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<table>
<thead>
<tr>
<th>Tax Calculation</th>
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<tr>
<td>Federal Tax (29%)</td>
<td>36.25</td>
</tr>
<tr>
<td>Less: Dividend Tax Credit (2/3 of Gross-up)</td>
<td>16.67</td>
</tr>
<tr>
<td>Federal Tax Payable</td>
<td>19.58</td>
</tr>
<tr>
<td>Federal Surtax of 8% (5% + 3%)</td>
<td>1.57</td>
</tr>
<tr>
<td>Total Federal Tax</td>
<td>21.15</td>
</tr>
<tr>
<td>Provincial Tax</td>
<td></td>
</tr>
<tr>
<td>51% of $19.58</td>
<td>9.99</td>
</tr>
<tr>
<td>plus Provincial Surtax of 54.5% of 51% of $19.58</td>
<td>5.44</td>
</tr>
<tr>
<td>Total Tax Payable</td>
<td>36.58</td>
</tr>
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</table>

<table>
<thead>
<tr>
<th>Charitable Donation</th>
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</thead>
<tbody>
<tr>
<td>Federal Tax Credit (29% x $67.50)</td>
<td>19.58</td>
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<tr>
<td>Federal “Surtax” Credit (6% x 19.58)</td>
<td>1.57</td>
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<tr>
<td>Provincial Tax “Credit”</td>
<td></td>
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<tr>
<td>51% x $19.58 plus Provincial Surtax of 54.5% x 51% x $19.58</td>
<td>15.43</td>
</tr>
<tr>
<td>Total Federal and Provincial Tax Credit</td>
<td>36.58</td>
</tr>
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</table>

**Net Tax Payable After Charitable Donation Tax Credit** $ 0
Revisiting Old Gift Planning Proposals

Consider how the application of the 75% annual income limitation for charitable donation tax credits changes the tax planning for charitable gifting. For the purposes of this analysis, the donors are individuals who implemented an estate freeze years ago which resulted in a transfer of equity growth to their children. Knowing their kids are now wealthier than they are, these parents will frequently prefer to gift $1,000,000 of preferred shares in the family holding company (“Holdco”) rather than any other asset. They know that the future growth will continue to be in the common shares owned by their children and all the parents have is fixed value preferred shares. They seldom receive dividends on these preferred shares. Assume these preferred shares have a redemption value of $1,000,000 and an adjusted cost base of nil. The deemed disposition upon death, assuming a 54% tax rate in British Columbia, will trigger a tax bill of $400,000. For the purposes of this analysis, assume that preferred shares are redeemed by way of deemed dividend with an effective tax rate of 36% on dividend income. The analysis without charitable gifting is set out in Case Study # II. It assumes that Holdco has a minimum of $333,333 in its RDTOH account.

### Case Study # II

**Redemption of $1,000,000 Holdco Preferred Shares - Without Private Foundation**

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<table>
<thead>
<tr>
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<tbody>
<tr>
<td>$1,000,000</td>
<td>FMV of Holdco Preferred Shares</td>
</tr>
<tr>
<td>Nil</td>
<td>Adjusted Cost Base</td>
</tr>
<tr>
<td>$1,000,000</td>
<td>Dividend Paid</td>
</tr>
<tr>
<td>$333,333</td>
<td>Holdco’s RDTOH Account</td>
</tr>
<tr>
<td>$360,000</td>
<td>Tax Payable</td>
</tr>
<tr>
<td>$640,000</td>
<td>After-tax Proceeds</td>
</tr>
</tbody>
</table>

**Result**

- Revenue Canada receives: $360,000
- Revenue Canada pays Holdco: $333,333
- **Private Foundation receives:** Nil
- Taxpayer has after-tax: $640,000

In 1996 the donor would have been advised to make a gift of the Holdco preferred shares to the private foundation under the rules which allow a complete avoidance of capital gains tax for a gift of capital property donated *en specie* to charity. This would have provided the individual donor with a $1,000,000 charitable donation tax credit for an asset gift. Holdco would subsequently redeem the shares and the deemed dividend would be received by the charity which is tax exempt. This planning would provide the individual donor with a net personal charitable donation tax credit of $250,000. It would provide the private foundation with $1,000,000 in cash which would come from Holdco rather than the individual donor. It also would present a very small tax risk in that there is an anti-avoidance provision in
subsection 129(1.2) dealing with dividend payments which have “one of the main purposes” being the acceleration of the refund of the RDTOH account. The results of this gift planning are set out in Case Study #III.

### Case Study # III

**Gift of $1,000,000 Holdco Preferred Shares**  
**Redemption Utilizing a Private Foundation**

<table>
<thead>
<tr>
<th></th>
<th>FMV of Holdco Preferred Shares</th>
<th>Adjusted Cost Base</th>
<th>Holdco’s RDTOH Account</th>
<th>Donors Elect FMV as Proceeds of Disposition</th>
<th>Charitable Gift Tax Credit to Donors</th>
<th>Taxable Income to Donors</th>
<th>Donation Tax Credit</th>
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<tr>
<td>$1,000,000</td>
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<td>$1,000,000</td>
<td>---</td>
<td>$750,000</td>
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<tr>
<td>Nil</td>
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<td>---</td>
<td>---</td>
<td>---</td>
<td>---</td>
<td>$750,000</td>
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<tr>
<td>$333,333</td>
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<td>---</td>
<td>$750,000</td>
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<tr>
<td>Gift Property</td>
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<td>$1,000,000</td>
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</table>

**Therefore**  
- Nil --- Tax Payable by Donors
- $250,000 --- Unused Donation Tax Credit

**Result**  
- Revenue Canada receives: Nil
- Revenue Canada pays Holdco: $333,333
- **Private Foundation receives:** $1,000,000
- Taxpayer has after tax: $250,000
- After-tax value of tax credit $135,000

Taxpayers have used corporate funds of Holdco rather than personal funds to fund Private Foundation.
1997 Gift Planning with Preferred Shares

Subsequent to the annual income limitation for charitable gift tax credit being increased in 1997 to 75% of taxable income, this gift would be restructured. The shares would not be donated to the private foundation, but would be redeemed while still in the taxpayer’s hands. This would avoid any risk, however slight, that subsection 129(1.2) would be invoked to block the repayment of the $333,333 of RDTOH. The donor would make a simple cash gift of $675,000 and avoid any valuation problems which flow from asset gifts which require donation receipts for gifts-in-kind. The donor would not only avoid paying any tax on the receipt of the $1,000,000 dividend payment, but the donor could retain $325,000 tax free. The results of this planning are set out in Case Study #IV.

<table>
<thead>
<tr>
<th>Case Study # IV</th>
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<tbody>
<tr>
<td>$1,000,000 Holdco Dividend Payment</td>
</tr>
<tr>
<td>$675,000 Gift to Private Foundation</td>
</tr>
</tbody>
</table>

| $1,000,000 | --- | FMV of Holdco Preferred Shares |
| Nil     | --- | Adjusted Cost Base |
| $333,333 | --- | Holdco’s RDTOH Account |
| $1,000,000 | --- | Dividend Payment |
| $675,000 | --- | Charitable Gift Tax Credit to Donors |

Therefore

| Nil     | --- | Tax Payable by Donors |
| $250,000 | --- | Unused Donation Tax Credit |

Result

Revenue Canada receives: Nil
Revenue Canada pays Holdco: $333,333
Private Foundation receives: $675,000
Taxpayer has after tax: $325,000
Many donors will prefer the planning proposed in Case Study #IV to that in Case Study #III. In both the donors have effectively used corporate funds of Holdco rather than personal funds to fund the endowment that their private foundation. The new planning, however, avoids the extra step of donating shares as a gift-in-kind and any valuation complications. In addition, this charitable gift has enabled the taxpayer to personally receive money from Holdco without the payment of tax to Revenue Canada. The ratio of donating $2 to the private foundation for every after-tax dollar kept by the shareholder looks quite attractive when one remembers that Revenue Canada is also remitting $1 to Holdco for every $2 the taxpayer is giving to the private foundation. This planning also avoids any of the difficulties in donation “non-qualifying securities” to a charity and does not involve a loanback. Charities do not seem to do as well in the 1997 planning as they did previously as they receive only $675,000 rather than $1,000,000. One can predict, however, that there will be more donors willing to give $675,000 out of dividend income than there were donors willing to give preferred shares worth $1,000,000.

Conclusion

Canada needs more financial resources devoted to the charitable sector at this time of government cutbacks and increased social need. The people best able to fund charities are the individuals with the financial capacity to make six, seven or eight figure gifts. Such gifts require sophisticated tax planning. Sophisticated donors are not going to make gifts of this magnitude until there is certainty on the new rules and the new legislation is passed.

The people who have the financial capacity to make large gifts may be less inclined to do so if they feel that they have been targeted as the “bad actors” in the philanthropic sector. There is no doubt that the proposed changes aimed at preventing gifts of non-qualified securities and loanbacks are aimed at large donors. The rhetoric surrounding these changes has always been couched in allegations of abuses. While the proposed legislations on such issues to date apply equally to all types of qualified donees, it is likely that in the future the punitive provisions will be focussed exclusively on private foundations.

With the history of the evolution of the changes in 1997 it is clear that Finance and parts of the charitable sector are positioning private foundations to be the institutional embodiment of philanthropic “bad actors”. This was first clear in February when private foundations were the only excluded type of qualified donee from the enhanced giving provisions related to gifts of publicly traded securities. Given that the value of such securities are determined by trading on the open market, it is difficult to think of many situations where a private foundation could abuse the privilege of receiving gifts of such securities. Indeed, it would seem to be much better public policy to encourage private foundations to have an investment portfolio primarily consisting of publicly traded securities rather than real estate and private company shares. If the legislation ultimately introduced to Parliament in December does allow gifts of non-qualifying securities and loanbacks to all qualified donees except private foundations, Finance has clearly moved to the position that non-qualified securities and loanbacks in and of themselves are not bad tax policy but only if such gift planning involves private foundations.
The other thing which the charitable sector needs is long-term stability in its tax policies. The reduction of capital gain inclusion for gifts of publicly-traded securities has been brought in with only five year time line and after which it will either be repealed or extended. No such review has been placed on the increase of a charitable donation tax credit or deduction to 75% of taxable income. It is doubtful, in my opinion, that 75% is a sustainable rate for all qualified donees on a level playing field. The planning opportunity with which a 75% tax credit or deduction present when combined with dividend tax credits and capital dividend accounts are extremely attractive. As illustrated in this paper, why would a donor make a $1,000,000 gift of private corporation shares for a net benefit of a $250,000 charitable donation tax credit when those shares can be redeemed in the individual’s hands and the donor can retain $325,000 cash and only needs to give charity $675,000? If Finance thought that they had a political struggle with parts of the charitable sector with regard to the 1997 proposals impacting gifts of non-qualified securities and loanbacks, the political problems will be much greater when it seeks to reduce the charitable donation tax limit.
Appendix I

February 21, 1997

The Honourable Paul Martin MP, PC
Minister of Finance
House of Commons
Ottawa, ON
CANADA

Dear Mr. Martin:

Re: Charity Provisions in February 18, 1997 Federal Budget

I watched your Budget Speech with a great deal of interest and anticipation because of rumours that it would contain enhanced tax incentives for gifts to charities. I was pleased that in your speech you drew attention to the fact that one of the elements of the charitable sector in Canada which is lacking in comparison to the United States is the number and magnitude of gifts in a form other than cash. The single greatest repository of wealth in Canada is the private corporation holding the entrepreneur’s business interests and investments. Consequently, I was appalled that your Budget will effectively prohibit Canadian entrepreneurs from donating private corporation shares to charities of any description. It will even prohibit charities holding such shares received in past gifts from accepting further cash gifts. Further, it will prohibit universities, hospitals and even the Canada Foundation for Innovation from forming effective private sector partnerships to promote research as acquiring any equity or debt participation will attract punitive taxation. Paragraph 21 of the Notice of Ways and Means certainly belies your claim that the Budget contains “no new taxes”.

While the Budget was billed as “Good News - No New Taxes Budget”, that is not the result for charities. Unfortunately, last month I had advised an elderly widow not to donate a large capital contribution to her private foundation as there might be good news in the Budget. Although she intended to give cash, yesterday I had to advise her not to do so because the “Good News - No New Taxes Budget” imposes a new tax equal to 50% of the amount of the gift. This is because the foundation still holds shares in a family controlled corporation which is the basis of the family’s wealth that her deceased husband had given to it at the time of his death. I am in the process of advising my clients to make no new gifts of even cash to a private foundation or any charity which holds shares or debt obligations of corporations which do not deal at arm’s length with the donor or members of the donor’s family.

Yesterday I had lunch with a client who owns a minority percentage interest in a business interest in Canada which is worth well over one hundred million dollars. He has a doctorate from a leading university and wants to donate most of this fortune to academic research as he has no children.
Unfortunately, it is a contractual term of his joint venture agreement that he must hold 100% of his business interest in a corporation controlled by him. The “Good News - No New Taxes Budget” results in a new 50% tax if he gives these shares to the private foundation he set up several years ago. I had to tell him that the “new 50% tax” applied even if he gave those shares to a public university. I am also advising him to change the charitable bequest in his Will.

Today I had lunch with an elderly client who wanted to take advantage of the “Good News - No New Taxes Budget” by giving a large six figure gift of publicly traded bank stock. He realized that he could not give it to his private foundation so was considering giving it to a university to which he has given nearly $5 million in a variety of gifts in the past several years. All but one of his gifts had been cash but the exception included preferred shares of a “corporation that does not deal at arm’s length with the donor”. As those shares paid dividends on a monthly basis at a rate higher than bank deposits, the university did not exercise its option to have the shares redeemed when it was given to it. The result is that a post-Budget gift to this university would trigger a new 50% tax. However, the donor could make the gift of bank shares to a hospital to which he had also made cash gifts of nearly $5 million in past years because it held no shares in his corporations. This seems rather perverse tax policy as this gentleman in his mid-80’s had forgotten that the university still held shares in his company. Again, I had to advise him to take the university out of his Will until those shares are redeemed.

I am certain that you are aware that the majority of private foundations in the United States are funded with shares of corporations which the donor built and controlled. While many of the largest of these donors had taken their corporations public prior to making such a gift, the vast majority of funders hold their wealth in corporations which are not listed on public stock exchanges. Subsequent to your “Good News - No New Taxes Budget”, it is no longer possible for entrepreneurs to donate their shares in such private corporations to any charity either while they are alive or upon their death without attracting a new tax equal to 50% of the gift. While some lawyers who are more aggressive than me may be prepared to argue that once the donor is dead there can be no question of dealing at arm’s length, I am not ready to render the legal opinion that a charity which is run by the deceased’s widow and children is immune to the new 50% tax when the day after the deceased’s death the private foundation holds shares in a corporation controlled by the same widow and children. Even for a gift to a university, the corporation continues to deal at non-arm’s length with the donor’s personal representatives through his or her estate after death.

The Income Tax Act’s definition of a debt obligation appears to include a personal or corporate cheque. Consequently, the “Good News - No New Taxes Budget” imposes a new 50% tax if a donor gives a repeat gift to any charity within five years paid by cheque. How much credence is one to give to the Notice of Ways and Means? If I give $10,000 to the United Way this month and my daughter gifts it a cheque for $50 next month, does her $50 cheque force the United Way to pay a tax of $5,000 on my gift?

There is no doubt in my mind that the cumulative effect of your 1996 and 1997 Budget proposals will be to defer and limit the endowing of charities. In 1996 you provided an incentive to defer capital donations until death because of the increase in deductibility to 100%. The “Good News - No New
Taxes Budget” not only imposes a new 50% tax if entrepreneurs give shares in their private corporations to charity, it also effectively removes the donor’s ability to increase the donation limit on gifts of capital property to eliminate 100% of the tax on capital gains. This benefit introduced in the 1996 Budget is only available if the shares are transferred en specie to the charity. Further, even if the donor gives shares of corporations listed on public stock exchanges to a private foundation, the donor is denied the 50% reduction in the resulting taxable capital gains.

The practical reality is that the increase of the donation limit to 75% of income removes almost any incentive to make a gift unless there is an imminent taxable disposition. You are a wealthy sophisticated entrepreneur yourself and know that your personal tax advisors will persuasively counsel you not to make an irrevocable gift of a large block of capital to endow a charity when you can retain ownership and donate 75% of the income earned by your corporations in the subsequent years in which the income is earned. Better yet, your corporations can pay you dividends personally. If you donate two dollars of dividend income to charity, you can pocket one dollar of taxable dividend income with the payment of no tax. If your corporation is an investment corporation with refundable dividend tax on hand, Revenue Canada will remit one dollar of tax paid money to the corporation for every three dollars of “taxable” dividends paid to you personally. With this type of flexibility and tax result, why would anyone irrevocably alienate capital unless faced with tax on disposition or unless the donor has a specific charity project which must be immediately funded? Why would a donor want a private foundation given the hostility expressed towards them in the “Good News - No New Taxes Budget”? How many people who do not make an irrevocable gift of capital to charity will continue to give even 75% of the income to charity five years later?

This type of analysis from the donor’s professional advisor will result in the 75% limit increasing the amount of cash gifts out of realized annual income. However, it will reduce gifts of large capital property. Gifts may increase for current projects but irrevocable gifts of capital property for long term endowments will decrease. The point of moving capital into a foundation was primarily to eliminate taxation of future income, dividends and capital growth in an era in which the donation limit was 20% of income. I know your officials have an antipathy to loanbacks. Whatever problems they present, at least the capital was irrevocably committed to charity, disbursement quotas prevented undue accumulations and section 189 penalty taxes required a fair rate of return be paid to the private foundation. Rather than address these problems in a reasonable way, the Notice of Ways and Means applies a scorched earth policy to private foundations. Even considering your antipathy to private foundations holding debt obligations and shares of related corporations, I consider it unconscionable that you would apply a new 50% tax to future gifts to charities which have not divested themselves of such instruments without highlighting that policy change in your Budget Speech. I suspect that the $5,000,000 of new money which your Budget allocates to Revenue Canada Charities Division to identify and collect these new taxes from charities has the potential to produce more revenue than any other $5,000,000 allocation in Revenue Canada’s budget.

Your “Good News - No New Taxes Budget” creates other new taxes for operating charities. You trumpet an $800 million Canada Foundation for Innovation to help universities and hospitals do advanced research. Your officials must know that universities and hospitals spin off hundreds of
corporations with royalty and patent agreements and retain equity participation. What your Budget did not say is that you have applied a new 50% tax to a university or hospital acquiring shares or providing debt financing to these corporations which necessarily do not deal at arm’s length with the charity. Why would you call for new public-private partnerships in funding this research in your Budget Speech while imposing a new 50% tax on the newly created Canada Foundation for Innovation to the extent it succeeds?

Albeit sophisticated solutions can be crafted to many of these and other problems created by the Notice of Ways and Means, any charity not able to reconfigure the form of the donor’s gift or divest themselves of offending assets prior to the gift being made will be charged with a new 50% tax. Private foundations will continue to be an important, if crippled, component of the charitable sector. The question is whether the average philanthropist will want to engage in such complicated planning or whether he or she will simply not make capital gifts to endow private foundations. If philanthropists do not endow private foundations today, the charitable sector will not be able to receive grants from them tomorrow.

I am sure that the lobbyists for the community foundations and large charities who convinced you to neuter Crown foundations and cripple private foundations are very pleased with your “Good News - No New Taxes Budget”. I do not consider the changes to be in the longterm best interests of the sector. You seek public acclaim for creating a “level playing field” by eliminating the ability of citizens to obtain a 100% deduction for a gift to the federal government’s Debt Reduction Fund while simultaneously destroying the “level playing field” that private foundations had enjoyed until this Budget. I hope that you are open to consultations with experts other than the lobbyists who talked you into this disaster prior to implementing the legislation. You will not succeed in your stated goal to increase gifts in a form other than cash if you eliminate the possibility of giving shares in a private corporation. You will not increase the number and magnitude of endowments for the charitable sector generally if you cripple private foundations.

Yours sincerely,

Blake Bromley
Appendix II

March 6, 1997

The Honourable Paul Martin MP, PC
Minister of Finance
House of Commons
Ottawa, ON
CANADA

Dear Mr. Martin:

Re: Level Playing Field for Crown Corporations

I write this letter as the person who proposed and drafted the first provincial legislation incorporating Crown Foundations, being the University Foundations Act in British Columbia. Crown Foundations as originally proposed were designed for and restricted to post-secondary education institutions and hospitals. Because governments provide substantially all of the funding for these institutions, it was intellectually consistent to treat donations to foundations created exclusively for their benefit as donations to the Crown. While there are a few Crown Foundations which have subsequently been created for broader purposes such as funding cultural groups, they are usually limited to funding groups which qualify by virtue of having received government grants in the previous year. While these new foundations have been created, they have attracted almost no funding.

It is ironic that Crown Foundations are losing their preferred status in order to level the playing field. When they were created I argued that they were needed to level the playing field for universities and hospitals because Canadians have an historic aversion to giving to institutions citizens believe they already fund through taxes. Many times I have publicly spoken about early conversations with David Lam (long before he became Lieutenant-Governor) in which he established the principle that the only two causes to which he would not contribute were universities and hospitals because people already “gave at the office” through the payment of taxes and private sector support would lead to a reduction in government funding. David and Dorothy Lam were the first million dollar donors to each of the Crown Foundations for UBC, Simon Fraser University and the University of Victoria. These Crown Foundations used tax preferences to level the psychological playing field and succeeded in overcoming the donors’ reluctance to give to universities.

I am unhappy that the message which many potential donors have taken from your Budget Speech is that you are concerned that the private sector is donating too much to universities and hospitals. One client who has given millions to each of his favourite university and hospital through Crown Foundations called to ask me if the Minister of Finance was trying to discourage people like him from giving to universities. He then proceeded to seek advice as to how he would direct his next large donation to his
private foundation. One wonders if you realize the extent to which people who admire your leadership in reducing the deficit and bringing discipline to government spending have interpreted your reduction of the status of Crown Foundations as your personal disapproval of the success which universities have had in attracting private sector funding.

Another adverse inference as to the attitude of the Minister of Finance to universities and hospitals has been drawn from your new 50% tax if they acquire shares in or provide debt financing to corporations which do not deal at arm’s length with the university or hospital. This new tax is not comprehensible to my clients in the high tech and medical fields who see universities and hospitals as potential partners whose contributions need to be recognized in equity participation. This new tax has certainly cast doubt upon your call for new public-private partnerships in funding research through the Canada Foundation for Innovation.

One of the genuine problems which your immediate removal of the 100% Crown Gift tax credit presents is that most large donations are made over a three to five year period. I have had donors call and ask whether they are legally obliged to continue a gift pledge schedule when the recipient can no longer provide a Crown Gift receipt. Another client who had made three out of four installment payments on a fully paid life insurance policy which named the Hospitals Foundation of British Columbia as the irrevocable beneficiary of a multi-million dollar life insurance policy came in to see me seeking assurance that this Crown Foundation would be in legal existence at the time of her death. Knowing that such a foundation had no independent funding for administrative costs, I was not able to give such an assurance.

It would be much better if you re-instated the 100% tax credit for Crown Gifts now and announced that the issue of a level playing field will be evaluated in five years together with the assessment of the impact of the 50% reduction of inclusion of taxable capital gains when giving shares in public companies to charities. This will put everyone on notice that you will review this issue but not send the message that you are so unhappy with Crown Foundations that it was necessary to precipitously downgrade them. I think that the symbolism of downgrading Crown Foundations, which to almost all donors means primarily universities and secondarily hospitals, is far more important to these institutions’ future fundraising potential than the 25% reduction of the donation tax credit.

Yours sincerely,

Blake Bromley
Appendix II

April 2, 1997

Mr. Jim Peterson
Chairman
House of Commons Standing Committee on Finance
Room 424-N, Centre Block
Ottawa, ON
K1A 0A6

Dear Mr. Peterson:

I have been told that you have been invited to speak at the plenary session of the National Conference of the Canadian Association of Gift Planners in Montreal on April 20 immediately before I do. You will know from the copy of my letter to the Minister of Finance dated February 21 which I previously sent you that I have serious technical concerns about Resolution 21 of the Notice of Ways and Means Motion. Receipt of that letter has not yet been acknowledged by the Minister of Finance and I have been advised by many sources that his officials are treating it as one lone criticism among a plethora of uncritical plaudits.

The purpose of this letter is not to cover those issues again as I know that technical drafting is the responsibility of Finance officials rather than your Committee. Rather it is to provide you with advance notice that my “big picture” analysis of this Budget differs as radically from that of the Department of Finance as does my technical analysis. Although a few of my clients have had this analysis since prior to the February 21 letter being sent, the majority of conference delegates will be hearing it for the first time in Montreal. I am providing you with an advance “heads-up” notice so that you will not be caught unawares of the views I will express.

I believe the February 18 Federal Budget does not level the playing field with Crown Foundations but in fact creates a far greater competitive advantage for them. My February 21 letter put “level playing field” in quotation marks and is worded very carefully because every one of the horror stories outlined in that letter result from new taxes which apply only to charities. Crown Foundations are immune from all of the taxes applied in Resolution 21 and now can solicit gifts of shares and debt of private corporations which charities cannot. Further, constitutional law prevents the federal government from imposing a tax on the provincial crown. I doubt even the drafters of this legislation pursuing whatever private agenda is driving them would go that far.

Resolution 21 should be completely withdrawn. Public charities are being asked to give up their opportunity to receive gifts of shares and debt obligations of private Canadian corporations in exchange for the opportunity for donors to receive a greater tax incentive for gifts of publicly traded securities. In a week in which we have seen Bre-X collapse, one wonders about the wisdom of this. Private
foundations are not even given that opportunity as the playing field is tilted against them. I suspect that charities which initially were extremely enthusiastic about this Budget will come to feel that, like Esau, they have sold their birthright for a mess of pottage.

My second point will increase their disillusionment with the significance of the reduction in capital gains inclusion. Most analysts have not told them that the Budget documents have not disclosed the impact of minimum tax on gifts of appreciated securities. Finance officials know that the minimum tax calculation will add back the 62.5% of the capital gain which is not taxed for purposes of calculating the minimum tax under Section 127.5. If a consequent relieving amendment was planned, I am certain it would have been highlighted as additional good news. They also know that the donor can only utilize the donation tax credit for the 37.5% of the gain which was included in taxable income. Therefore donors cannot even use any charitable or Crown donation tax credit carry forward from previous gifts or the excess donation receipt from this gift to avoid the minimum tax.

The “Good News” Budget document which provides calculations of tax results of these gifts would be more credible if it at least alluded to the minimum tax problem. I can assure you from personal experience that potential donors of large gifts of appreciated securities will not be amused by the Budget rhetoric when told a gift of securities with a capital gain of $1,000,000 results in a minimum tax bill of nearly $100,000 assuming the donor has only the minimum exemption of $40,000. Given the choice between paying $95,000 minimum tax immediately for a gift to a public charity or foregoing $195,000 of tax savings which could only be used in future years as sufficient taxable income is generated for a gift to a private foundation, one donor chose to donate her appreciated public securities to her private foundation. As the securities had a substantial cost base, the amount of the gift was considerably more than $1,000,000. This decision was taken in part as a gesture of defiance both to a Budget which applies a scorched earth philosophy to private foundations and to public charities which have applauded creating a “level playing field” with Crown foundations while not raising a murmur of protest about destroying the level playing field for private foundations.

I suppose the good news is that the minimum tax problem can be reduced if the donor has enough other taxable income. Consequently, public charities will find that the 75% limit is effectively almost as good as the 100% limit as donors must trigger additional taxable income to reduce the minimum tax payable. This will generally result in delaying much of the gift as donors reconfigure it into a multi-year gift. However, this assumes that the donor receives prior advice on how to reduce minimum tax. Many of the affected donors will be elderly widows with substantial assets but extremely modest annual income. Having been seduced by projections of tax savings in 1997, they will have a rude introduction to minimum tax in April 1998. Again, one wonders if this is in the long-term best interests of the charitable sector. Having personally experienced some of the ostracism which follows from criticizing the Budget in pre-election Ottawa, I have some understanding why, but no sympathy for, charities not speaking out on these issues. Surely the Budget’s call for strengthening Canadians’ confidence in the charitable sector includes telling donors the whole truth on issues such as minimum tax.

It is ironic that the result of these other changes is that the reduction of the taxable income limit to “level the playing field” does not really hurt universities and hospitals which have Crown Foundations in their
competition for donors. While the downgrading is very important in symbolic terms, most donors can
donate quite comfortably with the 75% limit. Where universities are hurt is that it is no longer possible
for corporations controlled by them to donate all of their taxable income to their Crown Foundation, but
must necessarily pay tax on 25% of their taxable income. Such corporations often arise from the
research the Budget purports to encourage.

The horror stories I will tell in Montreal will not be about clients whom I have been able to advise to
avoid the problems in Resolution 21. However, a crisis is building as more and more donors are
becoming aware of how wide Finance has cast its tax net. Donors who originally were only delaying
making gifts until clarification of Finance’s intent with regard to Resolution 21 is announced are now
quietly abandoning planned gifts as they realize with the pending election it will be up to a new
Parliament to determine changes. Instead, in Montreal I will talk about situations where million of dollars
of tax have already been triggered. Many gifts in kind made in December 1996 have been caught
unawares by this tax when persons related to the donor bought the donated property from the charity
and did not complete the transaction prior to February 18. Revenue Canada Charities Division has no
more discretion to waive or ignore this tax liability than Revenue Canada does to arbitrarily refuse to
collect the tax due on my personal income.

Just as I have given you a “heads-up” on the CAGP conference, you might be wise to give the Prime
Minister a “heads-up” that Resolution 21 may result in a little guerrilla warfare during the election
campaign. Private foundations and donors who make donations of shares and debt instruments of
private corporations have no effective representation among lobby groups in the charitable sector and
are frustrated that Finance officials will not even acknowledge concerns such as those set out in my
letter of February 21. Resolution 21 is not just a disaster but will quickly become an emergency for
funding in the charitable sector. If Finance officials do not immediately withdraw Resolution 21, all
donations which could be adversely affected will grind to a halt. The charitable sector cannot afford the
paralysis which will result in waiting the months and years it routinely takes Finance officials to “tinker”
with legislative “fine tuning”. Fortunately, some donors will willingly and with full legal advice respond to
the pleas of charities and make donations which trigger the tax in Resolution 21 in the belief that your
government will be too embarrassed to collect it. More aggressive wealthy and prominent citizens are
considering working in concert with prestigious charities during the election campaign to actively
embarrass prominent Liberals. They will encourage them to take advantage of the favourable publicity
involved in being identified with high profile projects funded by charitable donations. After the photo-
ops and participation in public announcements, they will challenge Revenue Canada Charities Division
to take 50% of the donated funding away by collecting the 50% tax. It is a sign of the anger which is
building towards this 50% tax and the absence of dialogue that strategies to ambush Liberal politicians
are being considered. While you might not welcome this action, you should be grateful that people are
prepared to act decisively to alert the government to this funding problem.

Having received so much favorable publicity from the “Good News” Budget with regard to charities, it is
unfortunate that the government is going to have to suffer the political ill will of charities when they
realize that they have been denied access to gifts of shares and debt of private corporations, and have
an even less level playing field with regard to Crown Foundations. It would be much better if the
government retained the “Good News” and simply withdrew the “Bad News”. It should then ask the House of Commons Standing Committee on Finance to continue its work and to come back with recommendations which reflect consultations with broad cross-sections of the charitable sector rather than the limited number of privileged lobbyists who have had direct access to officials at the Department of Finance. Until your Committee has completed its work, the government should give charities a reprieve from Resolution 21 and Crown Foundations a reprieve from the reduction in their charitable donation limit. As indicated in my attached letter of March 6 to Paul Martin, I believe that the symbolic significance of the downgrading of Crown Foundations is much more important than the 25 point spread in the donation credit limit. If such a consultative process was undertaken, I am certain your Committee and the officials at Charities Division who daily deal with the problems arising in the charitable sector could devise workable solutions to the alleged problems in the charitable sector.

Yours sincerely,

Blake Bromley