IMPEDIMENTS TO CHARITABLE GIVING

SUBMISSION TO HOUSE OF COMMONS STANDING COMMITTEE on FINANCE

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The House of Commons Standing Committee on Finance is to be commended for examining the incentives for charitable giving. Charities are finding it increasingly difficult to find the money necessary to fund the work that, in the words of the Supreme Court of Canada, is of "special benefit for society". Parliament has periodically legislated fiscal incentives to encourage individuals and corporations to voluntarily make donations to registered charities and other qualified donees. While these incentives do generate more giving, Parliament should also recognize the long-term impact on the charitable sector of relying on newer and ever more generous fiscal incentives to motivate funding. This strategy should be carefully and critically examined from a philosophical perspective as well as being subjected to an economic analysis.

Rather than seek additional tax incentives, my submission focuses on technical provisions in the existing tax laws related to gifting that are blocking hundreds of millions of dollars of donations that would otherwise be made under the existing incentives. My legal practice for more than three decades has been almost completely devoted to issues important to the funding and operations of charities. I take pride in the fact that I advised on charitable gifts totaling more than $100 million in many of those years, including last year. However, last year I also advised donors against making gifts of much more than an additional $100 million. Admittedly, it is a lot easier to persuade potential donors to take a million dollars off the table and put it back in their own pockets than it is persuade them to push it off the other side of the table into a charity's pocket. However, it is sad when the donation fails to take place not because a donor lacks capacity or goodwill because the donor fears CRA will attack a gift which is not simple cash or publicly traded securities.

Obtaining sophisticated gifts from large donors is a battle that charities are losing. Most Canadians with enough wealth to consider million dollar donations hold that wealth in private company shares and real estate rather than cash or publicly traded securities. If the charitable sector is going to truly benefit from the wealth of Canadians it must unlock the wealth represented by private company shares. One of the keys to unlocking such wealth is to provide greater tax incentives for donations of private company shares and real estate. My submission does not ask for additional fiscal incentives. Instead, it seeks to unlock this wealth by simply removing barriers in the current policies on valuation and "loanbacks".

Describing technical tax rules to tax lawyers is complex and difficult and usually involves too many references to a myriad of subsections in the *Income Tax Act* (*ITA*). Therefore, I will tell the story of some advice I provided just last month to a client who approached me about potentially making a gift of approximately $100 million. Telling this story might illustrate how the existing legislation and CRA's audit policies discourage donors from making large gifts to charities. The issues would not be any less problematic if the quantum of the gift was only $1 million.

My client is a wealthy individual who has donated many millions of dollars to both her own private foundation and public charities. In the past, substantially all of her donations have been cash so she did not confront the problems I will describe to you today. However, giving cash meant that her donations were limited by cash available and her taxable income in any one year. Increasing her donation to $100 million level was only possible if she donated shares in her private company ("PriCo Shares"). My client, like most wealthy Canadians, holds her real wealth in

private company shares and real estate. Like many wealthy Canadians, she started PriCo with partners and so does not own 100% of the company. Her fellow shareholders have an indirect interest in what happens to the PriCo shares after she donates them because it will impact the value of their own shares.

Parliament, in its wisdom or folly, has provided greater tax incentives when a donor gives the actual shares or real estate *en specie* instead of giving the cash that results from the sale of these assets. Assuming that my client could find a ready purchaser for her PriCo Shares, the amount of charitable donation tax credits she can use are reduced if she simply sold the PriCo Shares and gave the charity $100 million cash. Assuming the sale of the PriCo Shares resulted in a taxable capital gain of $50 million, my client can only use $37.5 million of her charitable donation receipt to reduce the taxable capital gain to $12.5 million if she gives cash. If she gives the PriCo Shares directly to the charity, my client can use $50 million of her charitable donation receipt to reduce the taxable capital gain to zero. Consequently, as her tax lawyer, I will advise my client to donate her PriCo Shares rather than cash even though it is more complicated than giving cash.

Gifts of assets such as PriCo Shares are also necessarily more complex for the recipient charity. The charity must sell the PriCo Shares to obtain cash. However, before even agreeing to accept the gift, the charity must determine the fair market value of the PriCo Shares. This means that both the charity and the donor should separately and independently incur the substantial costs of having the PriCo Shares appraised. It is both expensive and time consuming to undergo such an appraisal. Because she consulted me at the beginning of December, I advised my client that such an appraisal could not be completed prior to year end.

The cost of an appraisal and the time needed to complete it became inconsequential concerns once my client began to focus on the practical realities of an appraisal. An appraisal requires letting the appraiser scrutinize the assets, debt and business plan of PriCo and evaluate current and future cash flow projections to determine the value of the business. No donor wants to divulge all this proprietary information to a charity. There is too great a risk that confidential information will be talked about as the charity compares the appraisal it paid for with the appraisal paid for by the donor. However, CRA views such appraisals as the only legitimate way to determine the fair market value of the PriCo Shares.

My submission is that it would be much more sensible to value donated shares in a private company based upon the amount of money the charity receives when selling those shares. Appraisals may be the most reasonable basis for valuing real estate. However, even public companies are not valued based upon an appraisal of the underlying assets, debt and cash flow projections. Donations of public companies are valued on the basis of the trading price at the time of the gift. That makes sense because there is a public market with arm's length purchasers. However, when selling a fractional interest in a private company, the most likely purchaser is the donor or a person related to the donor through family or business connections. If the private company shares donated are less than 100% of the shares in the company, both the donor and the other shareholders are generally very opposed to the shares ending up in the hands of a complete stranger. Nor does the donor normally want the recipient charity to become a permanent shareholder in PriCo.

The donor, being the owner of the shares and completely familiar with the business operations of the company, is the person best able to estimate the fair market value of the shares without an intrusive formal appraisal. If the donor arranges for the charity to sell the shares for 100% of the amount for which the charity issued a charitable donation receipt, then the charity has undisputedly received the fair market value listed in the receipt it issued. This immediate monetization is more important from a policy perspective than focusing only on the methodology of determining fair market value and whether the PriCo Shares are sold to an arm's length third party.

Unfortunately, CRA will attack such planning because there is no formal appraisal. This is the case even though CRA acknowledges that the current law does not require an appraisal. CRA will also attack such a plan on the basis that the transfer of the PriCo Shares was not a "gift" at law because the parties had "agreed" that the shares would move in a "circle" from the donor to the charity and back to the donor or a person who does not deal at arm's length with the donor. The fact that this planning reduces the costs and difficulties of an appraisal while

guaranteeing that the charity receives full compensation for the fair market value listed in the donation receipt does not change CRA's position. Nor does the fact that the donor is impoverished and the charity enriched when this "circle" is completed satisfy CRA that the initial transfer was a gift.

As is common when a donor wants to make a multi-million dollar donation to a charitable organization, my client is a director of the charity she wants to benefit. Consequently, the *ITA* deems her PriCo Shares to be "non-qualified securities" when she donates them to this charity. This means that she cannot utilize her charitable donation tax credit until the gift is "monetized" when the PriCo Shares are sold. If the PriCo Shares are sold for less than $100 million, the value of her charitable donation tax credit will be reduced accordingly. She is penalized because she will still be deemed to have originally disposed of the PriCo Shares for $100 million and will be assessed capital gains tax on this basis. The fact that the shares are monetized at a greater or lesser amount at a later date does not mean the fair market value was not $100 million on the date of the gift. The *ITA* provisions on valuing non-qualified securities based upon monetization already deviate from the fair market value determined by appraisal.

It was an absolute deal breaker for my client to learn that CRA required her to transfer her shares absolutely and with no agreement as to monetization in order for CRA to consider the transfer to be a gift at law. She could not protect herself or the other shareholders from the recipient charity deciding that it is in the best financial interests of the charity to hold the PriCo shares indefinitely because PriCo is such a valuable company. My client came to understand that it would be completely foolish for her to make the gift she had asked me about once I advised her that if the charity failed to monetize the PriCo Shares within 60 months, she would receive absolutely no charitable donation tax credit. Even worse, she will be assessed capital gains tax because she disposed of shares worth $100 million. Nor does she have any legal recourse to get the PriCo Shares back because she irrevocably gave them to the charity. This Committee needs to understand that it is irrational for wealthy donors receiving proper legal advice to make gifts to charities in these circumstances.

If the directors of a charity believe that the PriCo Shares are as good an investment as the donor thinks they are, the recipient charity's financial interests would be best served by retaining the shares. At law, it is not proper for the charity to make its decisions based upon the financial interests of the donor. Consequently, it is not correct for the charity's decision to be influenced by whether or not my client will ever be able to claim her charitable donation tax credit. The situation becomes much worse when the recipient charity is a foundation because the "excess corporate holdings percentage" rules will require the foundation to dispose of the shares on a timetable completely unrelated to market conditions or the price received. If the charity receives only $80 million, my client's charitable donation tax credit will be reduced on a *pro rata* basis.

The *ITA* allows the recipient charity to monetize the donation by selling the PriCo Shares to any party who is arm's length from the donor in return for a promissory note or other debt instrument. However, if the PriCo Shares are sold to any party not completely at arm's length from the donor in return for a promissory note or other debt instrument, it is considered to be a "loanback". The donor is penalized by having her charitable donation tax credit reduced by the amount of the "loanback". My client wanted her children to purchase the shares and keep her interest in PriCO in the family. However, like most children, they did not have $100 million cash available. Nor did it make economic or business sense to go to the bank at this time to borrow that amount of money. Unfortunately, my client's intention to give was frustrated by the "loanback" rules.

These harsh "loanback" provisions prevent the donor from negotiating the sale of "non-qualifying securities" to friendly related persons for debt. It is a travesty that the inability to negotiate the disposition of donated shares leaves the donor vulnerable to the recipient charity selling the donated shares to a related person in return for a debt instrument without her consent. She will have made an absolute gift so she cannot prevent the charity from selling the PriCo Shares to a related person. Consider the situation where the donor is a sworn enemy of her brother who wants to increase his stake in PriCo. If the brother is a good credit risk and will pay $20 million cash and sign a secured promissory note for the remaining $80 million at a reasonable interest rate, the charity is acting prudently in its best interests in selling to him. It is the proper legal decision in these circumstances for the charity

to act in its own best interests by selling to the donor's brother and to ignore the fact that this sale will result in a retroactive denial of $80 million of the donor's charitable donation tax credit.

CRA has not altered its administrative policies on requiring an absolutely unfettered transfer in spite of the recent decision of the Ontario Court of Appeal in *McNamee v. McNamee*. I have clients with cumulatively hundreds of millions of dollars worth of donations of private company shares to arm's length charities that CRA is threatening to disallow because monetization was negotiated prior to the gifts. The charities have received full value in cash and assets so there are no loanbacks. Charities cannot expect donors to make multi-million dollar donations of private company shares when CRA pursues assessing policies that are so hostile to donors.

The House of Commons Standing Committee on Finance should not only recommend the repeal of the *ITA's* loanback rules but should actively encourage the use of loanbacks. If a donor gives common shares in a private corporation to a private foundation or public charity, good public policy should encourage the charity to sell the shares immediately. The persons most likely to pay full value for a minority share interest in a private corporation are the donor or his family. Donors will not make such gifts if they cannot negotiate monetization.

My submission is that the *ITA* should legislate a Qualifying Loanback Debt instrument to enable donors to purchase donated non-qualified securities from any charities, including private foundations. Presumably, the interest rate would be 1-2% more than a fixed 5-year bank rate. Legislation could also require that the principal of the Qualifying Loanback Debt Instrument be secured by the non-qualifying security or other property being purchased and that it be fully repaid at the end of 5 years. The donor's charitable donation tax credit could be retroactively reduced by the amount of interest and principal of the Qualifying Loanback Debt Instrument not paid to the charity within 60 months of its issuance.

Introducing the concept of a Qualifying Loanback Debt Instrument does not increase the costs to the national treasury of making charitable donations. It does remove an intractable valuation problem and assist a charity to immediately monetize the non-qualified security. The charity will ultimately receive the amount listed in the official donation receipt or the donor will be re-assessed on the shortfall. The donor will have to bring any inflated value into his or her taxable income. More importantly, the donor will have to pay the charity the full inflated value. A donor will not generally inflate the value of an asset if that donor intends to buy it back.

Removing CRA's restriction on negotiating the subsequent monetization of donated assets and introducing the Qualifying Loanback Debt Instrument will become even more important if Parliament removes the capital gains inclusion on gifts of private company shares and real estate. If gifts are exempt from capital gains inclusion, linking valuation to proceeds of monetization will prevent abuse more readily than an expensive and complicated appraisal process. If this approach is adopted, it will be important to give the donor every opportunity and incentive to help the charity receive the highest possible amount when selling donated assets.

It is important for the House of Commons Standing Committee on Finance to recognize that there are opportunities to significantly increase the amount of donations to charities that do not require increasing tax incentives. Simply removing legislated impediments to good valuation and monetization policies will mean that lawyers and other philanthropic advisors can go back to encouraging large donations of private company shares and real estate instead of dissuading their clients because of the pitfalls and traps in the current legislation and CRA's assessing policies.

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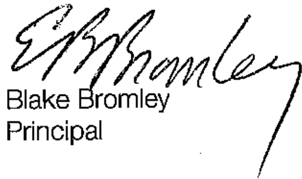
Per:



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