

SUBMISSION TO:

**HOUSE OF COMMONS
STANDING COMMITTEE ON FINANCE**

REGARDING:

STUDY OF CHARITABLE DONATION INCENTIVES

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I - INTRODUCTION:

I am an Associate Professor at the Faculty of Law at the University of Western Ontario. My research focus is on the income tax treatment of charities under Canadian law. Prior to becoming an academic I was an associate lawyer in the estates, trusts and charities department at the Toronto office of a major international law firm. I welcome the House of Commons' Standing Committee of Finance (the "Committee") study of donation incentives.

The recommendation set out in this submission is based on a research paper I prepared for the Canadian Tax Journal which was recognized by the Canadian Tax Foundation with the 2010 Douglas J. Sherbaniuk Distinguished Writing Award.¹ Resort may be had to this background paper for a detailed explanation of the problem identified and policy solution proposed in this submission.

II - EXECUTIVE SUMMARY:

The test currently applied to identify what charitable donations are eligible for donation incentives under the *Income Tax Act*² (the "Act") is overly restrictive and complicated. It results in lost charitable donations and heightened administrative compliance costs. In addition, it undermines the tax policy objectives donation incentives are meant to achieve. Further, it is indecipherable in many respects except to those with highly specialized knowledge in the fields of property, trust and tax law. Even to a specialized audience there are elements to the test that cannot be reconciled. Previous reform efforts have been unsuccessful at producing a test that is either simple to understand or attentive to underlying tax policy considerations. The ideal policy solution is a new statutory definition of "charitable donation". The definition proposed in this submission will introduce new revenue sources to charities while reducing administrative compliance costs. It would remedy a significant shortcoming with current law and regulatory practice.

III - BACKGROUND:

An income tax code providing tax concessions for charitable donations must deal with three key issues:

1. Eligible Recipients: To what kind of institution must a taxpayer donate in order to qualify for a donation incentive?
2. Design Features of Donation Incentive: Should the donation incentive take the form of a tax deduction or tax credit? If a credit, what should be the amount of the credit? Should the credit be refundable? How, if at all, should capital gains tax apply to donations of capital property?

¹ A. Parachin, "Reforming the Meaning of 'Charitable Gift': The Case for an Alternative to Split Receipting" (2009) 57:4 Canadian Tax Journal 787-838.

² RSC 1985, c. 1 (5th Supp.), as amended.

3. Eligible Contributions: What sorts of contributions to eligible recipients qualify for donation incentives?

Eligible Recipients:

Identifying eligible recipients of charitable donations raises difficult questions surrounding the legal meaning of “charity”. Although there is a widely recognized need for reform to this aspect of current law, it is a highly complex and politically sensitive issue of tax policy that could all too easily dominate the resources of the Committee. It is an issue that would be most constructively studied as a discrete topic rather than as but one part of a broader study of donation incentives.

Design Features of a Donation Incentive:

This issue is likely to be the one over which the Committee will receive the most submissions, especially from advocates of an enhanced donation incentive (the so-called “stretch tax credit”) and/or exempting donations of private securities and real estate from capital gains tax. While there is much to be said about these reform proposals (both for and against), it would in my view be a mistake to proceed with new donation incentives before clarifying what contributions to charities qualify for donation incentives in the first place. To do so would amount to building on an unstable foundation.

Eligible Contributions:

There is a dire need to clarify what contributions to charities qualify for donation incentives. One of the major failings of current law and regulatory practice is that the range of donations to charities eligible for donation incentives has never been clearly established. The Act provides that only those contributions to charities qualifying as “gifts” are eligible for donation incentives. The Act does not, however, define the term gift. A vast body of cases and regulatory publications deal with this topic but it has not produced a test for identifying charitable gift transactions that is sufficiently clear or well-developed for planning purposes. In fact, it is impossible to succinctly state how gift has been defined in the authorities without having to acknowledge a number of bewildering and seemingly unprincipled qualifications.

IV – PROPOSED POLICY SOLUTION:

The Act should be amended to include a statutory definition of what transactions qualify for the tax concessions for charitable donations. Given the unhelpful jurisprudence built up around the term “gift” it is essential that this term be abandoned in favour of something else. The ongoing use of the term gift will risk the continued application of the very authorities that the proposed definition is meant to displace.

One possibility would be to substitute the term “gift” with “charitable donation”. An ideal definition of charitable donation would make explicit that any transfer of property

to or for the benefit of a charity, whether by way of common gift, trust, sale or any other form of transaction, qualifies for donation incentives to the extent that it confers value on the charity. Donation receipts could only be issued for the amount by which net value was conferred on the charity.

The requirement for property has the effect of excluding donations of services. In theory, there is no reason why donations of services should be excluded since such contributions are consistent with the basic purpose of donation incentives. However, the tax revenue implications of recognizing such donations and the heightened difficulties associated with valuing and auditing them supply plausible reasons for their exclusion.

V – BENEFITS OF PROPOSAL:

Adopting the proposed definition of charitable donation would yield many benefits.

The proposed definition would have the effect of incentivizing new donation arrangements and thereby allowing charities to benefit from donations that might not otherwise get made.

The proposed definition would introduce greater simplicity to the law and thereby reduce administrative compliance costs for charities and enforcement costs of regulators.

The proposed definition would introduce greater coherence to this area of law. Under current law and regulatory practice the only issue that ultimately matters – whether a donation confers a net enrichment on a charity – all too often gets emasculated by a fixation on considerations with no apparent policy significance. The proposed definition would focus the attention of courts and regulators on the issue that ultimately matters. It would better align tax practice with underlying tax policy

VI – WHY IS A DEFINITION OF “CHARITABLE DONATION” NECESSARY?

The test applied to identify eligible contributions under current law and regulatory practice is inconsistent with the tax policy goals behind donation incentives. Although not everyone agrees, the most widely held view is that donation incentives should ultimately be understood as a policy instrument to help finance the goods and services provided by charities. On this view, the true tax policy behind donation incentives is simply to generate revenues for charities by reducing the after tax cost of donations.

So the primary policy concern at play when it comes to determining whether a given donation should be eligible for donation incentives should be whether the donation to some measurable extent economically equips the recipient charity to achieve its charitable mission. If it does, there is a strong policy case for recognizing the donation as a charitable gift for income tax purposes.

The authorities have, however, fixated on considerations possessing little to no relevance to whether a donation meets this essential standard. For example, donations have been

denied the status of gift for no other reason than that they did not take the legal form of a common law gift. Specific examples include the forgiveness of a debt owing by a charity, allowing a charity to occupy land for no or below fair market value rent and selling valuable property to a charity for a nominal price. Similarly, donations have been considered ineligible for donation incentives because they were made further to a legal or moral obligation and/or because the donor, though he or she benefitted the charity, did not donate further to a truly charitable motive and thus lacked the requisite donor intent.

Strictly speaking none of these considerations have tax policy significance. A donation arrangement can achieve the tax policy objective of financing charitable goods and services regardless of whether it takes the form of a common law gift, whether it was made voluntarily or whether the donation was the product of a truly generous motive. In fairness, not all authorities have strictly enforced such flawed gift criteria. However, the exceptions are haphazard and usually left unexplained in the authorities. This has resulted in a cloudy legal test for identifying gifts.

Donations involving trusts have proven to be a particular challenge. Rather than donate directly to charities donors sometimes instead establish trusts under which charities are given an entitlement (fixed and/or discretionary) to income and/or capital. The Canada Revenue Agency has understandably concluded that no gift can be recognized by the creator of the trust where the beneficial interest in the trust given to the charity cannot be accurately valued (such as where the amount, if any, that will ultimately be distributed to charity is left to the complete discretion of the trustees). However, the Canada Revenue Agency applies gift criteria that sometimes results in no gift being recognized even where valuation is not an issue.

This results in circumstances in which property is distributed to charity via trusts but neither the taxpayers establishing the trusts nor the trusts themselves can claim that gifts have been made for tax purposes. Again, this is inconsistent with the basic purpose of donation incentives to incentivize contributions to charity.

Further confusing matters is that proposed legislative amendments (specifically, proposed subsection 248(40) of the Act) will result in the meaning of “gift” varying depending upon whether the context entails a donation to charity from a private donor or a donation from one charity to another.

Proposed amendments to the Act released in 2002 – the so-called split-receipting rules (proposed subsections 248(30)-(32) – were intended to remedy the incoherence plaguing the meaning of gift. However, these rules (which have yet to be enacted) do very little in this regard. Under the split-receipting rules specious considerations pertaining to motive, voluntariness and transactional form inexplicably continue to play a role in identifying charitable gift transactions.

VII - ADVERSE CONSEQUENCES OF STATUS QUO:

This state of affairs yields a number of negative consequences for the charitable sector.

First, charities are losing out on potential donations. Excluding from the definition of gift donation arrangements that should in theory attract donation incentives removes the incentive for donors to make such donations. In some cases donors will either restructure their donations so as to qualify for donation incentives or proceed with a donation notwithstanding that it will not qualify for any donation incentives. But in other instances the overly narrow definition of gift presumably results in lost donations.

Second, charities face heightened regulatory compliance costs because they are required to retain legal counsel for answers to what should (and could) be simple questions surrounding the meaning of gift. Further, the contradictions and inconsistencies in the authorities inflate legal costs because they increase the time lawyers must devote to doing opinion work in this area.

Third, the underdeveloped state of current law unnecessarily complicates regulatory enforcement. Inconsistent cases and regulatory publications are more difficult to enforce and they furnish a basis for taxpayer appeals.

VIII - CONCLUSION:

One of the fundamental problems plaguing current tax law and regulatory practice is the absence of a satisfactory test for identifying the range of charitable donations capable of qualifying for donation incentives. In many respects the test currently applied contradicts the tax policy objectives behind donation incentives. It unjustifiably denies recognition to a number of donation arrangements that serve the very goals donation incentives are meant to achieve. Moreover, the test is inconsistently applied. All of this results in lost donations, tremendous confusion surrounding the essential standards eligible donations must meet and heightened regulatory compliance costs for charities. The best way to remedy this state of affairs is for income tax law to adopt a new statutory definition of “charitable donation”.