

New Tax Era for Private Foundations

- Charitable Giving to Private Foundations Enhanced
- New Shareholdings Regime for Private Foundations

A Notice of Ways and Means Motion tabled in the House of Commons on November 13, 2007, enhances Canada's tax incentives for individuals, corporations and trusts that donate publicly listed securities to private foundations, by extending the capital gains exemption to these gifts. However, to address the government's concerns regarding potential self-dealing opportunities for a private foundation and persons not dealing at arm's length with the foundation, the draft legislation restricts a private foundation's significant holdings in corporations and may expose private foundations to increased tax governance. The draft legislation refines draft rules released on October 2, 2007, that implement measures introduced in the March 19, 2007 federal budget.

For additional help understanding the implications of these changes, contact your PricewaterhouseCoopers adviser or any of the individuals listed on page 6.

Charitable giving to private foundations enhanced

The draft legislation reduces from 50% to nil:

- the capital gains inclusion rate for gifts of qualifying publicly listed securities from any donor (i.e., individuals, trusts and corporations) to private foundations; and
- the inclusion rate for donations to private foundations of publicly listed securities acquired through employee stock options.

The draft legislation applies to gifts of qualifying securities to private foundations made after March 18, 2007. **Example 1** on page 2 illustrates this change. The draft rules parallel changes introduced in the 2006 federal budget¹ for donations made after May 1, 2006, of qualifying publicly listed securities to public charities. For details regarding qualifying securities and the tax benefits, see PricewaterhouseCoopers' *Tax Memo* "Tax Relief for Charitable Donations Enhanced," dated June 30, 2006, at www.pwc.com/ca/taxmemo.

The reduced inclusion rate for qualifying securities acquired through employee stock options applies to an employee who deals at arm's length with his or her employer, exercises options that have been granted by the employer to purchase publicly listed securities and then donates the securities to a qualified donee within 30 days of their acquisition. As a result of the draft legislation, the individual will be entitled to an employment deduction that offsets the related employment income inclusion, as illustrated in **Example 2** on page 2.

An employee may be able to take advantage of the reduced inclusion rate by doing a cashless exercise, i.e., exercising the stock option and directing the broker or dealer to sell the securities immediately, and then donating all or part of the proceeds to charity.

1. Amendments to section 38(a.1) of the *Income Tax Act* were enacted on June 22, 2006, by virtue of Bill C-13, the *Budget Implementation Act, 2006*, receiving royal assent.

Example 1: Donation of qualifying securities

Assumptions:

- Donation of qualifying publicly listed securities with a fair market value of \$11,000 and a cost of \$1,000.
- The donor is an individual with a combined federal and provincial/territorial marginal tax rate of 45%.

	Sell shares and donate cash	Donate shares	
		Before March 19, 2007	After March 18, 2007
Proceeds of sale/donation	\$11,000	\$11,000	\$11,000
Less: cost	(1,000)	(1,000)	(1,000)
Capital gain	10,000	10,000	10,000
Tax on capital gain	2,250	2,250	\$0
Less: donation tax credit (\$11,000 x 45%)	(4,950)	(4,950)	(4,950)
Net tax benefit from donation	\$2,700	\$2,700	\$4,950

Example 2: Donation of qualifying securities acquired through employee stock options

Assumptions:

- Donation of qualifying publicly listed securities with a fair market value of \$11,000 that are acquired through the exercise of employee stock options that have an exercise price of \$1,000.
- The donor is an individual with a combined federal and provincial/territorial marginal tax rate of 45%.

	Sell shares and donate cash	Donate shares	
		Before March 19, 2007	After March 18, 2007
Income inclusion (\$11,000 - 1,000)	\$10,000	\$10,000	\$10,000
Less: employee stock option deduction	(5,000)	(5,000)	(5,000)
Less: charitable donation deduction	\$0	\$0	(5,000)
Net income inclusion	5,000	5,000	\$0
Tax on income	2,250	2,250	\$0
Less: donation tax credit (\$11,000 x 45%)	(4,950)	(4,950)	(4,950)
Net tax benefit from donation	\$2,700	\$2,700	\$4,950

New excess corporate holdings regime for private foundations

As mentioned, the tax relief for donations of qualifying publicly listed securities to private foundations applies for donations made after March 18, 2007. To address its concerns regarding the potential for self-dealing by persons not dealing at arm's length with private

foundations, the federal government has proposed a regime that could:

- limit a private foundation's shareholdings;
- require the foundation's shareholdings of all classes of any corporation to be monitored;
- increase the annual information return reporting requirements of the foundation's shareholdings;
- require the foundation to report information regarding shareholdings of relevant persons (see **Relevant person** below); and
- require shares to be divested (depending on the level of shareholdings of the foundation and those of relevant persons).

Draft legislation relating to the excess corporate holdings regime generally applies to taxation years of private foundations commencing after March 18, 2007 (but see **Transitional rules** below). Definitions relating to the excess business holdings regime apply after March 18, 2007.

The proposed regime is intended to increase transparency and accountability by private foundations and combat potential abuses by persons that control private foundations. It restricts shareholdings by private foundations in both public and private corporations, whether obtained before, on or after March 18, 2007, and whether or not tax relief was obtained by a donor in connection with the shares. Transitional rules are intended to allow foundations that have excess corporate shareholdings at March 18, 2007, to come into compliance in an orderly manner.

Relevant person

The draft legislation introduces the definition of "relevant person" for the purposes of applying the excess corporate holdings regime. "Relevant person" is generally any person (including an individual, trust, or corporation) that does not deal at arm's length with:

- the person that controls; or
- any non-arm's length group of persons that controls, the foundation (as if the foundation were a corporation). Non-arm's length persons include individuals related to each other by blood, marriage, common-law or adoption.

However, a relevant person does not include:

- a person that is considered not to deal at arm's length with the private foundation solely because of a right (other than a right whose exercise is contingent on the death, bankruptcy or permanent disability of an individual):

- to, or to acquire, shares or to control the voting rights of such shares;
- to cause the corporation to redeem, acquire or cancel shares owned by other shareholders;
- to, or to acquire or control, voting rights in respect of the shares; or
- to cause the reduction in voting rights of shares owned by other shareholders; or
- an individual who:
 - is 18 years or older;
 - lives separate and apart from an individual who controls or is a member of a related group that controls the private foundation; and
 - the Minister of National Revenue (the Minister) has agreed, after reviewing an application from a private foundation, is an individual that is dealing at arm's length with all controlling individuals.

Shareholding ranges

The excess corporate holdings rules are applied to each class of shares. They apply to all classes, irrespective of voting or other rights, held by the private foundation and are based on the size of shareholdings relative to the outstanding shares of each class. **Table 1** outlines the rules. In some cases, provincial legislation may also limit the level of shareholdings that a charity may retain.

The draft rules apply only to private foundations. Although the rules introduce new considerations when planning share purchases and receiving gifted shares, they generally do not affect the tax treatment of a donor's gift. However, the complexity, along with the disclosure and divestiture requirements, necessitates thoughtful planning when in-kind gifts of shares to private foundations are contemplated.

Table 1: Shareholding Ranges and Required Action

	Action required by private foundation	Holdings of outstanding shares (for any class) owned by:	
		Private foundation	Private foundation and relevant persons (or "total corporate holdings percentage")
Safe harbour	No actions required of the private foundation.	2% or less (considered an "insignificant interest")	Any
Monitoring and reporting	The private foundation must track and report: <ul style="list-style-type: none"> • the percentage of the issued and outstanding shares of that class at the end of the year held by: <ul style="list-style-type: none"> - the private foundation; or - a relevant person that holds a material interest¹ in respect of that class; • the material interest¹ held at the end of the taxation year by a relevant person; and • a material transaction² of the foundation. 	Greater than 2%	20% or less
Mandatory divestiture	Monitoring and reporting requirements apply (above). To avoid penalty tax: <ul style="list-style-type: none"> • combined shareholdings of each class must be reduced to 20% (monitoring and reporting obligations continue); or • the foundation's shareholdings of each class must be reduced to 2% or less (safe harbour), before the divestiture deadline (see Table 2, below). In certain circumstances, the penalty tax may be satisfied by payment to an eligible donee.		Greater than 20%

1. A person has a material interest in respect of a class of shares if that person holds:
 - more than 0.5% of all issued and outstanding shares of that class; or
 - shares with a fair market value that exceed \$100,000.
2. A material transaction includes a transaction or series of transactions or events in respect of shares of a class if the fair market value of the shares of the class that are acquired or disposed of by the private foundation or any relevant person at the time of the transaction or the end of the series exceeds the lesser of:
 - \$100,000; and
 - 0.5% of the total fair market value of all issued and outstanding shares of the class.

Excess corporate holdings and entrusted shares

The excess corporate holdings percentage is the percentage of a particular class of shares held by a private foundation and/or by relevant persons that hold a material interest in respect of that class (collectively called the “total corporate holdings percentage”) that exceeds 20%. If the private foundation has an insignificant interest in respect of the class of shares, then the excess corporation holdings percentage is 0%.

However, if a private foundation has more than 20% holdings of the following types of shares (“entrusted shares”):

- the shareholdings were acquired by way of donation before March 19, 2007, and the gift of shares is subject to a trust or to a direction that the shares be retained by the foundation; or
- a donation of shares was made after March 18, 2007, but before March 19, 2012, pursuant to terms of a will executed, or a testamentary or *inter vivos* trust created, before March 19, 2007, and not amended after that date,

the excess corporate holdings percentage is determined using the entrusted share percentage, rather than 20%.

Divestiture

When divestiture is required by the private foundation and/or the relevant person, its timing will depend on how the excess corporate holdings arose. As illustrated in **Table 2**, the period for divestiture generally ranges from the taxation year in which the excess holdings arose to the ten subsequent taxation years.

Divestiture is required for a particular taxation year if the foundation has a divestment obligation percentage exceeding zero.

The divestment obligation percentage is generally:

- the previous year’s divestment obligation percentage; plus
- the sum of all net increases in the excess corporate holdings percentage in respect of each class of shares that was allocated to the particular taxation year; less
- the sum of all net decreases in the excess corporate holdings percentage at the end of the year allocated to the particular taxation year.

A net increase in the excess corporate holdings percentage in respect of a class of shares of a corporation is the amount by which the excess corporate holdings percentage at the end of the year exceeds the excess corporate holdings percentage at the end of the preceding year. Net increases in the excess corporate holdings percentages give rise to divestment obligations. The timing of those divestment obligations depends on the allocation of net increases to one or more specific taxation years of the foundation, which in turn depend on the origin of the excess shareholdings.

A decrease in the excess corporate holdings percentages first reduces the divestment obligation percentage of that taxation year. Any remaining portion reduces the divestment obligation percentage of the subsequent taxation years in chronological order.

Any remaining net decrease for the year expires if:

- at the end of a taxation year there is a net decrease; and
- the divestment obligation percentages for that year and all subsequent taxation years have been eliminated.

Table 2: Allocation of the net increase in the excess corporate holdings percentage

		Allocation of the net increase in the excess corporate holdings percentage
Cause of excess corporate holdings	Shares purchased by the private foundation	To the taxation year in which the acquisition occurred
	Shares purchased by a non-arm’s length person or acquired by way of donation to the private foundation from the non-arm’s length person	To the subsequent taxation year
	Shares acquired by way of donation to the private foundation from an arm’s-length person or by a repurchase of shares by the corporation	To the second subsequent taxation year
	Shares acquired by way of bequest	To the fifth subsequent taxation year
	Special circumstances, such as when mandatory divestiture would depress the share price or securities regulators impose requirements	The Minister has discretion to extend the deadline by up to five additional taxation years; application by foundation required

Transitional rules

If a private foundation's total corporate holdings on March 18, 2007, referred to as "original corporate holdings," exceed 20%, transitional rules allow the foundation to divest the excess holdings over a period of five to twenty years. Original corporate holdings exceeding 20% must be divested at a minimum rate of 20% every five years through divestitures by the private foundation or by relevant persons, until the excess is eliminated.

For the transitional rules to apply, a private foundation should determine and report (in the information return for its first taxation year that begins after March 18, 2007) its original corporate holdings percentage. All monitoring and reporting requirements relating to excess corporate holdings on the annual information return also apply to shareholdings that are subject to the transitional rules.

Anti-avoidance rule

An anti-avoidance rule introduced in the draft legislation provides that if a private foundation or a relevant person has engaged in a series of transactions the purpose of which is to avoid the application of the definition of material transaction, each of the transactions or series of transactions is deemed to be a material transaction.

Reporting and public disclosure

All reporting described in **Table 1** is to be provided to the Canada Revenue Agency as part of the foundation's annual T3010A Charity Information Return.

For private foundations that hold more than an insignificant interest in a corporation, the Minister can publicly disclose:

- the name of the corporation; and
- the portion of the total corporate holdings percentage of the private foundation (by class) that is attributable to holdings of the private foundation and to holdings of relevant persons.

Penalty and revocation provisions

Failure to comply with the divestiture requirements will attract the sanctions and penalties outlined in **Table 3**.

Table 3: Penalties

	Infraction	Penalty ¹
Failure to divest excess corporate holdings	First infraction	5%
	Repeat infraction for same failure within the last five years	10%
Failure to disclose²: • a material transaction ³ ; • a material interest held by a relevant person ⁴ ; or • total corporate holdings percentage. ⁵	All infractions	

1. The penalty for a taxation year is equal to the product of:
 - the penalty percentage;
 - the divestment obligation percentage for year; and
 - the total fair market value of all issued and outstanding shares of the class.
2. For the taxation year.
3. In the taxation year.
4. At the end of a taxation year.
5. At the end of the taxation year, unless at no time in the taxation year the private foundation held greater than 2% in respect of the class.

A private foundation's registration can be revoked if it has a divestment obligation percentage at the end of any taxation year.

Draft legislation

The press release accompanying the Notice of Ways and Means Motion states that the federal government will further review the excess corporate holdings rules in order to provide relief in respect of unlisted securities held on March 19, 2007, and to consider the treatment of corporations wholly-owned by private foundations.

Provincial/territorial rules

Quebec's May 24, 2007 budget stated that it will harmonize with the federal rules. Ontario has confirmed to PricewaterhouseCoopers that it will also do so. Although none of the other provinces or territories has made similar comments, the federal changes will automatically apply in all of the other jurisdictions for individuals and (except in Alberta) for corporations. Therefore, it is uncertain whether Alberta will parallel the federal rules for corporate tax purposes.

PricewaterhouseCoopers can help

Charitable gifting strategies, including gifts of shares, can be beneficial to both the donor and private foundation but may inadvertently expose the recipient foundation to increased governance regarding annual tax reporting requirements.

For help with tax governance, annual tax reporting requirements for your private foundation, and developing and implementing your philanthropic plan, including the structuring of gifts to your private foundation, contact your PricewaterhouseCoopers adviser or any of the individuals listed below.

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For assistance with this complex issue, please call or e-mail us.

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