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CHARITIES & NOT-FOR-PROFIT NEWSLETTER

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The Charities & Not-for-Profit Newsletter is published monthly by Miller Thomson LLP's Charities & Not-for-Profit Group as a service to our clients and the broader voluntary sector. We encourage you to forward the e-mail delivering this newsletter to anyone (internal or external to your organization) who might be interested. Complimentary e-mail subscriptions are available by contacting charitieseditor@millerthomson.com.

Inside

THE 2006 MILLER THOMSON FOUNDATION NATIONAL SCHOLARSHIP PROGRAMME

Since the creation and launch of its scholarship programme in 1995, the Miller Thomson Foundation has awarded a total of $1,550,000 to 1,550 promising students pursuing post-secondary education in Canada.

The purpose of the Miller Thomson Foundation scholarships is to encourage the attainment of higher education goals by top students in Canada who have demonstrated high academic achievement and made meaningful contributions to their schools and communities. One of Miller Thomson's core philosophies has always been the dedicated contribution of its lawyers to the wellbeing of the communities it serves, through support of public and social service programmes.

In 2006, 200 National Scholarships are available, each winner receiving $1,000 towards post-secondary education within Canada.

To obtain an application form and further information about the National Scholarship, please visit our website at www.millerthomson.com and then link to MT Foundation, or e-mail Lesley Lawson, Executive Director of the Miller Thomson Foundation, at llawson@millerthomson.com.

FEDERAL COURT REVIEWS CRA CHARITY AUDIT UNDERTAKING LETTER

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Until the March 2004 federal budget (as implemented in 2005), the only compliance tool available to the CRA Charities Directorate was to revoke the registration of a registered charity. Since the consequences of revocation were so severe (loss of tax exempt status, loss of ability to issue official donation receipts and a penalty tax equal to 100% of the revoked charity's assets) the CRA was loath to apply the revocation sanction. Thus, the CRA developed a practice of issuing what it referred to as "undertaking letters" that demanded that a charity "undertake" or promise to make certain changes to its operations in order to avoid revocation.

Since the undertaking letter process was based on administrative practice (as set out in CRA Guide T-4118, *Auditing Charities*) rather than statute, the ordinary appeal mechanism via judicial review by the Federal Court of Appeal otherwise available to a charity facing revocation was not available. As a result, a charity that received an undertaking letter would almost always comply with the CRA's demands even if the charity and its advisors believed on a reasonable basis that the undertakings were not all necessary. The alternative to compliance with the undertakings was to allow the CRA to revoke the charity's registration and then bring a judicial review appeal to the Federal Court of Appeal against the

revocation. Not only was this very expensive, but the Federal Court of Appeal judicial review mechanism for revocation appeals is widely viewed as being designed to make appeals difficult. As well, the consequences of losing the appeal (revocation of registration) were so severe that few charities were willing to risk a dispute with the CRA.

In late 2004, the Acorn Foundation, a private foundation with a Christian religious focus, was audited by the CRA. In response to its audit findings, the CRA issued an undertaking letter taking the position that money that the Foundation had borrowed from one of its principals for investment purposes constituted a debt that the Foundation was not permitted by the *Income Tax Act* to incur. The letter went on to require that the Acorn Foundation repay the allegedly improper loans, otherwise the CRA would proceed to revoke its registration.

Rather than agree with the CRA's position, the Acorn Foundation filed an application for judicial review in the Federal Court Trial Division seeking to quash the undertaking letter on a number of bases, including that the CRA had misinterpreted the relevant sections of the *Income Tax Act*. In response, the CRA filed a motion to strike the Foundation's application on the basis that the undertaking letter did not constitute a "decision" (as required in order to establish the Court's jurisdiction) but was really just the CRA's opening negotiating position.

In late 2005, Justice Russell of the Federal Court dismissed the CRA motion and confirmed that judicial review is available against an undertaking letter issued by the CRA. This decision confirms that it should not be necessary in future for charities to simply accept undertaking letters; instead, charities faced with questionable demands from the CRA have judicial review available to them as a means of challenging the CRA without risking immediate revocation of registration.

As an aside, the CRA's substantive position on private foundations borrowing to make investments has actually now been abandoned by CRA (see Amanda Stacey's article below for more details). Thus, the underlying issue in the Acorn Foundation judicial review should be capable of resolution without the need for further adjudication.

ONTARIO'S PHIPA FOUND "SUBSTANTIALLY SIMILAR" TO PIPEDA

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The Governor-General in Council issued an order on November 28, 2005, exempting "Health Information Custodians" in Ontario from the federal privacy legislation, the *Personal Information Protection and Electronic Documents Act* (PIPEDA). The order rules that Ontario's *Personal Health Information Act* (PHIPA) is substantially similar to PIPEDA in its application to Health Information Custodians with respect to the collection, use and disclosure of personal information by these entities.

"Health Information Custodians" (HICs) are defined in PHIPA to include health care practitioners, hospitals and other health facilities, homes for the aged and nursing homes, homes for special care, centres, programs or services for community health and mental health, pharmacies and labs.

Prior to the Exemption Order, a HIC could have found itself subject to both pieces of legislation if the HIC collected, used or disclosed personal health information in the course of commercial activities. The overlapping jurisdictions could have led to confusion regarding enforcement and remedies. While both PHIPA and PIPEDA are based on the same ten "Fair Information Principles," PHIPA is tailored specifically to the protection of personal health information in the custody of HICs and organizations that receive personal health information from HICs. For example, PHIPA provides detailed rules regarding consent by a substitute decision maker. The Ontario legislation is not limited to information obtained by HICs in the course of commercial activities and therefore has a much wider application in the health care sector.

The fundraising arm of a HIC is also subject to PHIPA, which provides guidelines (which are much clearer than PIPEDA's) regarding how consent to the collection, use and disclosure of personal health information for fundraising purposes may be obtained. Subsection 32(1) of PHIPA allows a HIC to:

collect, use or disclose personal health information about an individual for the purpose of fundraising activities only where,

(a) the individual expressly consents; or

(b) the individual consents by way of an implied consent and the information consists only of the individual's name and the prescribed types of contact information.

Such collection, use and disclosure may only be "for the purpose of fundraising activities undertaken for a charitable or philanthropic purpose related to the custodian's operations," and all fundraising solicitations must provide an easy way to opt out of receiving further solicitations (O. Reg. 329/04, paras. 10(2)1 and 3).

Further, paragraph 10(2)3 of the Regulations to PHIPA regulates the circumstances for obtaining implied consent by a HIC with respect to fundraising:

i. the custodian has at the time of providing service to the individual, posted or made available to the individual, in a manner likely to come to the attention of the individual, a brief statement that unless he or she requests otherwise, his or her name and contact information may be disclosed and used for fundraising purposes on behalf of the custodian, together with information on how the individual can easily opt-out of receiving any future fundraising solicitations on behalf of the custodian, and

ii. the individual has not opted out within 60 days of when the statement provided under subparagraph i was made available to him or her.

The Exemption Order provides the Ontario health sector with welcomed clarity regarding the sensitive issue of the privacy of personal health information.

REVENUE QUEBEC AND U.S. DONATIONS

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Under the Canada-United States Treaty, Article XXI, paragraphs 5 and 6, a person in one country can contribute to a recognized charity of the other country and obtain tax relief. These provisions are limited in scope since the usual domestic limitations apply and the deduction is limited to income generated in the other country.

Unfortunately Revenue Quebec has developed a policy of not recognizing US donations even though the taxpayer has US source income.

The Courts have recognized that tax treaties signed by Canada are not binding on the provinces and territories. However, for the provinces that do not manage their own tax system and rely on the federal system, the tax treaties signed by Canada apply automatically. Those provinces are: Newfoundland and Labrador, Prince Edward Island, Nova Scotia, New-Brunswick, Manitoba, Saskatchewan, British Columbia, Yukon, Northwest Territories and Nunavut for individuals and companies, and Ontario and Alberta for individuals only.

In Quebec, paragraph 725(a) of the *Taxation Act* provides that an individual may deduct any amount included in *income* for the year that is an amount exempt from income tax in Quebec or Canada pursuant to a provision contained in a tax agreement with another country. However, the tax recognition of charitable donations is in the form of a tax credit, or deduction from *tax payable*, not a deduction from *income*.

According to Revenue Quebec, in the absence of a tax treaty between Quebec and the United States, paragraph 725(a) applies only to an amount exempt from income tax, as opposed to a tax credit or similar tax relief.

Apparently, Revenue Quebec is aware of the problems caused by this lack of legislative harmonization. We will keep you informed of any further development in this area.

FCA REVERSES TAX COURT'S ART FLIP DECISION

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The Federal Court of Appeal put a damper on Christmas for hundreds of people who bought art from CVI Art Management (CVI) and then donated the artwork to charity. The Court, in a unanimous judgment, reversed a decision of the Tax Court of Canada and decided that the fair market value of the art was what had originally been paid for it. This decision in effect merges two separate test cases dealing with so-called art flips with a disastrous result to the donors.

The first test case was known as *Klotz* and came before Chief Justice Bowman of the Tax Court of Canada. Chief Justice Bowman found that the appraisals submitted in support of a fair market value far in excess of the very recent original purchase price could not stand up to scrutiny. The *Klotz* case was subsequently appealed to the Federal Court of Appeal and Chief Justice Bowman's decision was upheld.

However, soon after the *Klotz* case was decided, Justice Bell of the Tax Court released his judgment in the CVI case, then known as *Quinn*. Justice Bell took the position that the CVI valuations were much superior to the *Klotz* valuations and therefore determined that the fair market value of the donated art work was substantially higher than the purchase price. The CRA appealed that decision to the Federal Court of Appeal.

Justice Rothstein of the Court of Appeal took the position that the appraiser in the CVI case made a basic error in appraising each particular work of art. Justice Rothstein pointed out that the art could only be purchased as a group - there was no evidence that individual items could be purchased or donated. Justice Rothstein therefore found that the correct approach was to value each group of works purchased, not the individual items which made up the group:

> In this case, there was a market in which the specific groups of prints were traded. In 1997, CVI sold 35 out of 35 available groups, in 1998, 150 out of 155 available groups and in 1999, 298 out of 300 available groups. These sales indicate that there was a market for the specific groups of prints. Indeed, almost all the groups CVI had available for sale were sold. This was CVI's normal course of business. CVI and the taxpayers were dealing with each other at arm's length.
>
> The groups of prints purchased by the taxpayers were donated to charities or universities within two to six months of their purchase. If any of the taxpayers had wished to sell the groups of prints within that time frame, what price could have been obtained? The inevitable answer is that the price would have been, at most, the price for which that group of prints was being sold by CVI. If a higher price was sought, a knowledgeable potential purchaser would buy from CVI. In other words, CVI's price was the highest price each of the groups of prints would bring at or near the relevant time.

The upshot is that the Court decided that for donation purposes, the purchase price from CVI was the fair market value.

While there is always the possibility of a further appeal to the Supreme Court of Canada (and we understand that leave may be sought), there is some evidence that the CRA is now prepared to move against thousands of other taxpayers who bought low/donated high. Almost all of these cases had been on hold while *Klotz* and the CVI case worked their way through the Courts.

The rationale of the Federal Court of Appeal in the *Klotz* and CVI cases will not be conclusive in every case, of course, but the Court of Appeal decisions have certainly strengthened the CRA's position in dealing with past donors to valuation-based charitable donation programs.

DEBTS INCURRED BY CHARITABLE FOUNDATIONS - CRA POLICY CHANGE

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The Canada Revenue Agency has recently changed its policy on borrowings by charitable foundations. In an October 21, 2005 internal technical memorandum, the CRA took the position that a debt incurred for the purpose of acquiring investments would be viewed as a "debt incurred in connection with the purchase and sale of investments" and would therefore be permitted to be incurred by a foundation.

Subsection 149.1(3) and (4) are applicable to public and private foundations respectively. These provisions give the Minister the power to revoke a charitable foundation's charitable status in a number of circumstances, including where a foundation incurs certain types of debts. Paragraphs 149.1(3)(d) and 4(d) are identical and provide that the Minister may revoke the registration of a public or private foundation where the foundation:

> (d) incurred debts, other than debts for current operating expenses, debts incurred in connection with the purchase and sale of investments and debts incurred in the course of administering charitable activities; [emphasis added]

The CRA had previously interpreted the phrase "debts incurred in connection with the purchase and sale of investments" fairly strictly. It was their position that the type of debt contemplated by this phrase included only miscellaneous types of debts such as brokerage fees or other incidental amounts that might be incurred on either the purchase or sale of an investment. As such, if a charitable foundation had incurred a debt for the purpose of acquiring an investment, they were at risk of having their charitable registration revoked pursuant to either paragraph 149.1(3) or (4).

The CRA now takes the view that a debt incurred for the purpose of acquiring an investment is a "debt incurred in connection with the purchase and sale of investments" and will not result in revocation of charitable status. Thus, interest-free loans from a foundation's directors or members to enable the foundation to acquire investments, pay current operating expenses or expend on charitable activities should generally not be of concern. However, the CRA cautions that it will still review debt arrangements, particularly those involving non-arm's length parties, to ensure that there are no other compliance issues, such as personal benefit.

CRIMINAL CONVICTION / TAX PROBLEMS FOR PERPETRATORS OF FRAUDULENT CHARITABLE TELEMARKETING

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Some tax cases capture our attention for their outrageous facts - The *Arthur Zins v. The Queen* case is one of them.

Mr. Zins had already been convicted of fraud in the criminal courts on the basis of his illegal telemarketing activities when the CRA reassessed him to include the proceeds of his fraud in his income. In response to his reassessments, Mr. Zins appealed to the Tax Court on the following issues:

1. Did the activities of Mr. Zins permit him to claim that he was a "non-profit organization as defined in the *Income Tax Act* (the "Act")?

2. What was the amount of gross revenue earned and deductible expenses incurred from the telemarketing activity in 1998?

3. Was the amount of restitution paid by Mr. Zins in 2002 and 2003 a deduction in 1998? and

4. Was Mr. Zins liable for subsection 163(2) penalties under the Income Tax Act?

In June of 1998, Mr. Zins obtained part-time work with Xentel making telephone solicitations from the public for charitable activities of police and firefighter associations. He soon realized how readily people gave to these types of charitable organizations. Mr. Zins eventually established his own telephone solicitation business. Although he had no arrangement with any police/firefighter association, he distributed materials on the basis that he was fundraising for their charitable activities. His advertising included a phony charitable registration number. His plan was to donate only such funds to charity as there were donors who requested receipts. He would make the donations on behalf of what he referred to as "the Jewish Men's Group". The balance of the funds would be retained to expand the fundraising activity and to provide himself with some income.

Mr. Zins did not present any evidence of the structure, membership or activities of the Toronto chapter of the Jewish Men's Group. He did have a bank account under that name and he was the sole signing authority. He went through considerable effort in implementing his fundraising activity. He worked from home and actually hired two teenagers to stuff and stamp envelopes and other individuals with computer knowledge to assist in managing computer-generated lists of potential donors.

Mr. Zins was eventually convicted of fraud and ordered to make restitution in the amount of $38,272, being the amount seized by police. This full amount was released to charities in 2002 and 2003. As part of their criminal investigation, the police requested a forensic accountant's report. The Canada Revenue Agency (the "CRA") relied solely on this report for the purposes of a tax reassessment and did not undertake an independent review of monies received by Mr. Zins during the period.

Mr. Zins objected to the CRA reassessment on the basis that he was operating a non-profit organization through his involvement with the Jewish Men's Group in Toronto. The Tax Court judge found that the Jewish Men's Group referred to by Mr. Zins was a front for his own personal scheme. The Court found that Mr. Zins could not claim to be a non-profit organization; Mr. Zins then argued that his gross revenue from the telemarketing activity in 1998 was less than that as reported by the CRA. This case confirms the principle that the proceeds of crime are subject to tax and the tax dispute generally centres on the amount of revenue earned.

The forensic accountant’s report was not complete for purposes of a tax investigation so Justice Miller traced the movement of funds between Mr. Zins' various bank accounts. Following the flow of funds, and failing any other evidence from the CRA, Justice Miller concluded that the CRA's reassessment was higher than the income actually earned by Mr. Zins.

The next issue for the Court to decide was whether the restitution amount paid in 2002 and 2003 was a deductible expense to Mr. Zins in 1998. Justice Campbell held that Mr. Zins was not entitled to deduct the amounts seized by the police in 1998. Although Mr. Zins lost control of the funds when the police seized the funds in 1998, there was no absolute or unconditional obligation in 1998 for Mr. Zins to pay those amounts. As a result, Mr. Zins could not in 1998 deduct the amount paid by the way of restitution in the later years.

The final issue for the Court's determination was whether Mr. Zins should be assessed penalties under the *Income Tax Act*. Justice Miller found the taxpayer knowingly made or participated in the making of a false statement or omission on his tax return and therefore assessed penalties against him.

WHAT'S HAPPENING AROUND MILLER THOMSON LLP

The December issue of *Canadian Not-For-Profit News*, edited by **Arthur Drache**, contained the following articles by him: "Scary Decision-Making for Directors", "Imagine Canada Embraces Abolition of Two-Tier Tax Credit", "Revisiting Foreign Activity Rules", "CRA Mulls Issue of Rental Properties as Business", "Donation Statistics for 2004", as well as "Disclosure of Donor Records to CRA" by **Daniel L. Kiselbach** and **Jacqueline L. King**.

Robert Hayhoe's article "Finance Abandons Proposed Diligence Requirement for Charities Receiving Large Gifts" was published in the December 9, 2005 issue of *The Lawyers Weekly*.

On December 21, **Susan Manwaring**, along with Jo-Anne Ryan of TD Waterhouse Canada Inc. and Jill Nelson of the Canadian Cancer Society, appeared on a ROB TV's *Money Talks* segment "Charitable Giving: Self-Directed or Managed Giving -- You Decide!"

In late 2005, Thomson-Carswell released its annual editorial update of **Arthur Drache's** *Canadian Taxation of Charities and Donations* looseleaf service. **Robert Hayhoe** assisted **Arthur Drache** with the new material.

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