

ADVANCING *Issues*

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The Private Charitable Foundation. A Legacy of Giving.

By *Jamie Purves, Senior Vice President, Corporate Planning Associates*

If you are inclined to make substantial donations to charity either during your lifetime or through your estate you may want to consider establishing your own charitable foundation. Many wealthy families have used foundations as an effective tool for managing their philanthropic objectives. You don't have to donate millions to consider this approach. Gifts of several hundred thousand dollars can form the basis for an enduring legacy.

Steps to consider are the setting up of your foundation, funding it, maintaining its registered status and the ultimate use of the monies for charitable work.

Here are some of the more common motivations for creating a charitable foundation:

- You may wish to enhance the family or corporate name
- By including family members in the management of the foundation you help them develop their sense of charity
- The foundation structure may better suit a longer term philanthropic goal than a strategy of periodic giving
- You may wish for your charitable work to continue long after you're gone

- You may wish to provide a specific benefit to a charity rather than simply enhancing its general donations

There are two types of charitable foundations, public and private. Families tend to use a private charitable foundation, as they can fund and control it. Created by a corporation or through the use of a trust agreement, your private charitable foundation must be registered with CCRA. With registered charity status, a private charitable foundation is exempt from income tax and can issue tax receipts for donations received.

To qualify for and maintain its registered charity status a private charitable foundation must meet certain criteria as set out in the Income Tax Act. It must devote its resources to charitable purposes and activities; may not carry on any type of business activity; and must meet its disbursement quotas.

By contributing to your own charitable foundation you get the same tax benefit as if you contributed to The Canadian Cancer Society or any other registered charity. Assume you make a one-time gift to your foundation valued at \$500,000. Under the Income Tax Act, taxpayers with charitable donations over \$200

receive a tax credit at their marginal tax rate. This credit is applied, to a limit of 75% of net income in the year of contribution with any unused credit carried forward for up to five years. Careful planning should also be undertaken to ensure the full benefit of this credit is utilized. If the donation is by way of a bequest through your will, the credit is applied up to a limit of 100% of net income in the year of death and the preceding year.

I mention 'valued at' in the above example since qualifying donations can take many forms;

- Cash
- Securities (publicly traded stocks, bonds, mutual fund units)
- Real Estate
- Canadian Cultural Property
- Ecologically Sensitive Land
- Life Insurance Policies
- Residual Interest of a Trust or Estate

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What's It All About? (Alfie)

By John R. Ross, Chairman, Corporate Planning Associates

As we have all watched the stock markets gyrate over the last few months it is no wonder that our clients are growing increasingly concerned. I recently spoke to a friend in the investment business and asked him how things have been going over the past year. His answer was classic. He said "I got out of the investment business a year ago. I'm now a psychiatrist and spend all of my time reassuring my clients."

When the markets are crashing and the world is in turmoil it is difficult to remember that we have been here before. History is filled with crises, many much more severe than the current one, but that fact does not remove the anxiety and the dreadful feeling that you may lose all of your assets.

If we could only isolate ourselves from all bad news and simply go about our lives, everything would be perceived to be alright. Obviously that isn't a practical solution but perhaps if we go back to basics we can gain some comfort from the facts.

Fact #1. While most of us want to leave an inheritance for our family, our number one concern is usually a comfortable lifestyle for our spouse and ourselves. In most cases that requires a steady and reliable source of cash flow. Whether that cash flow comes from employment, pensions, RRIFs or investments is irrelevant because a buck is still a buck and as long as we have the cash flow it doesn't matter.

Fact #2. The markets will go up and the markets will go down. History shows that over time the markets always go up. Why do we forget this simple fact when they go down? We are inundated with mostly negative news when the markets are going down, however, when the markets suddenly go up as they did in mid March, there is no warning – it just suddenly happens.

Fact #3. When it comes to investment income we all have options. That is what I would like to discuss.

Let's assume that the financial objective is to generate \$5,000 a month of after tax cash flow. There are basically three options and each has its pluses and minuses.

Many people who describe themselves as "conservative investors" will usually think in terms of an interest bearing investment. Whether GICs, T-bills, bankers' acceptance, government bonds or some derivative the effect is that you will receive a fixed rate of return and that return is "guaranteed". With today's low rates of interest, you would earn from 3% for a short term T-bill to 5% for a long term bond. So for this exercise let's assume that you earn 5%.

If you are in the top tax bracket you will pay slightly more than 46% in taxes, which means that your net yield will be approximately 2.7% after tax. Therefore you would need to invest \$2,222,222 into your long bonds. If you opted for a more conservative, short term investment at 3%, you would net 1.62% after tax and require \$3,703,703. Ouch!

Another attractive option would be to buy an annuity. The advantage of this approach is that you can guarantee a fixed amount of income that will also enjoy certain tax advantages. Because annuity income is a combination of capital and interest, only a portion of the cash flow is taxed. The disadvantage is that at the last death (between you and your spouse) there is no capital to leave to your family.

A couple, both age 65, could contract to buy a joint life annuity that would guarantee them \$6,126.99 of monthly income before tax. This income would be paid as long as one of them is alive. Because only the interest portion of the annuity would be taxed they would

realize \$5,000 after tax. This guaranteed income would cost them \$1,039,204.

The approach that CPA has recommended for the majority of our clients is called a Systematic Withdrawal Plan (SWP). The mechanism of a SWP is really quite simple. You can automatically withdraw cash flow from a mutual fund and have a fixed amount deposited into your bank account on a monthly basis. Dealing with the objective of generating \$5,000 a month, here is an example of how it might work. We'll assume that the funds earn an average of 6% annually. I know, you're going to say that they sure haven't done this over the last three years but over the last 10 years the worst performance has been 6.5% and the best is over 11%. If you average 6% your after tax return will be 4.62% because capital gains are taxed at about 23%. In most funds the capital gains are deferred but for this exercise we will ignore any deferral. Generating \$5,000 a month will require a capital contribution of \$1,290,700. If you do average 6% the entire capital will be passed to your children. If you earn less you will reduce your capital but your original objective of providing \$5,000 a month will still be maintained. Even if the funds earn nothing you would still collect your \$5,000 a month for over 21 years.

If your yield was 8%, your after tax yield would be 6.16% and your capital requirement would be \$974,025.

We strongly believe that where the objective is to generate cash flow, the SWP approach is by far the most attractive. Unfortunately, the solution comes with the fact that markets fluctuate and if you can't deal with this you should take the annuity or the interest approach.

There are many other options such as real estate, income trusts, etc. but I have tried to stick to fairly simple, understandable and reliable approaches. Which approach makes the most sense to you?

Supreme Court of Canada Weighs in on the Reop Test

By Pamela Cross, Borden, Ladner Gervais LLP

In a recent pair of decisions, the Supreme Court of Canada restricted severely the use of the “reasonable expectation of profit” (commonly referred to as “REOP”) test in Canadian tax jurisprudence. Prior to these decisions, the Canada Customs and Revenue Agency (“CCRA”) regularly denied the deduction of certain business losses, if the taxpayer could not establish that he or she had a reasonable expectation of profit in connection with the venture giving rise to the losses. Where there was no REOP, the CCRA took the position that there was no source of income, a requirement under the Income Tax Act (“Tax Act”) against which a taxpayer could deduct his or her business losses. Notwithstanding the fact that the Tax Act does not use the phrase, “reasonable expectation of profit”, the REOP test had been employed successfully by the CCRA on many occasions.

The application of the REOP test has been criticized for years due to its apparent unfairness. Once REOP was found to apply, the losses that were not deductible would be lost forever – they could not be carried forward and applied in subsequent years in the event the venture eventually became profitable. In addition, the losses could not be applied to offset any future capital gain realized on the sale of the underlying assets used in the venture.

The Stewart Decision:

In *Stewart v. Canada* (2002 DTC 6983), the taxpayer owned four condominiums, all of which were rented out to third parties. In part because the condominiums were highly leveraged, resulting in high interest charges, the taxpayer incurred significant losses. Projections

from the promoters of the condominium project indicated that there would be negative cash flow for the first 10 years. The actual losses were even larger than anticipated.

The CCRA disallowed the losses on the basis that the taxpayer had no REOP. Both the Tax Court of Canada and the Federal Court of Appeal agreed with the CCRA, and the taxpayer appealed to the Supreme Court of Canada. Fortunately for Mr. Stewart, and many other taxpayers, the Supreme Court of Canada rejected the REOP test as the primary means of determining if a source of income exists.

Instead, the Supreme Court described the proper approach as two-fold: first, it is necessary to determine if the activity of the taxpayer is undertaken in pursuit of profit, or as a personal endeavour. If there is no personal or hobby element to the venture, then the activity will be considered a source of income, and no further analysis is required.

Second, in the event there is a personal element to the activity, it is necessary to determine if the activity constituted a source of income from business or property. The activity will still be considered to be a source of income if the taxpayer has undertaken the activity in a “sufficiently commercial manner”. To demonstrate the commercial nature of the endeavour, the taxpayer had to establish that his or her subjective intent was to make a profit, and that the activity had been carried on in accordance with objective standards of businesslike behaviour. Therefore, if there was a personal element to the venture, the existence of a REOP will be one factor, but not the only factor, in evaluating the commercial nature of the activity.

In applying this approach to the circumstances of Mr. Stewart, the Supreme Court of Canada found there was no personal element in the condominium investments, and as such, Mr. Stewart’s activities constituted a commercial venture. The Court also stated that Mr. Stewart’s hope of eventually realizing a capital gain on the condominium did not detract from the commercial nature of the rental operations. Such an expectation is consistent with an “ordinary business person’s understanding of ‘pursuit of profit’ and may be taken into account in determining whether the taxpayer’s activity is commercial in nature.” Having said that, the Court clarified that the mere acquisition of property in anticipation of an eventual gain does not, in itself, provide a source of income; however, an anticipated gain may be one factor in assessing the commercial nature of the taxpayer’s overall course of conduct.

The Walls Decision:

In the companion case of *Walls v. Canada* (2002 DTC 6964), released concurrently with the Stewart decision, the Court applied the new approach in circumstances where two taxpayers had invested in a highly leveraged limited partnership involved in providing mini-warehousing facilities. Upon finding that there was no personal element in the venture, the Supreme Court found that the REOP test had no application. Further, the Court stated that the fact that the taxpayers were motivated by tax considerations when they initially purchased their partnership interests did not affect the validity of the transactions, nor did it detract from the commercial nature of the venture.

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The Income Tax Act has clear guidelines for valuing each of these assets for the purpose of charitable donations. These guidelines should be thoroughly explored with your tax advisor prior to gifting.

Now that your foundation is funded, the Income Tax Act requires it to spend a prescribed amount each year, referred to as its disbursement quota. While this spending can be on its own charitable activities specific to your philanthropic intent, your foundation may also gift to other 'qualified donees' which are simply other charities.

In its most basic form, the disbursement quota for a private foundation in a given taxation year is 80% of the value of receipts issued in the previous taxation year plus 4.5% of the average fair market value of the foundation's remaining assets. Using the previous example of a \$500,000 contribution, your foundation is required to spend \$404,500. Barring further contributions by you to the foundation, its future philanthropic gifts would be reduced to a few thousand

dollars as the obligation to pay 4.5% of the average fair market value of the foundation's remaining assets continues regardless of donations.

If the vision for your foundation is to finance a sustainable and level gift, say a bursary or scholarship, there is a mechanism for reducing the disbursement quota. By providing written direction with the donation that it be held in trust for a period of at least ten years or by providing for a donation through your will, the annual disbursement quota falls to 4.5% of the prescribed value of the property, as a minimum. In this way, with prudent investment, the foundation can become a lasting legacy.

Establishing a private charitable foundation may not be practical for everyone. There are costs associated with this strategy of both time and money, which your financial advisor will help to clarify. In the end this approach can create a win-win scenario for your family and the community at large.

Supreme Court of Canada Weighs in on the Reop Test

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Implications:

As a result of these two decisions, the CCRA will no longer be able to use the REOP test in circumstances where losses are incurred in connection with an activity having no personal element. The REOP test will still be relevant in circumstances where a personal element exists.

The Tax Act does, however, contain specific provisions which restrict the deductibility of particular expenses, as well as a general overriding requirement that all business expenses be "reasonable in the circumstances". With the loss of the REOP test, the CCRA will be forced to focus its efforts on reviewing the reasonableness of individual expenditures, should it wish to deny business losses to taxpayers involved in commercial activities.

This article is necessarily of a general nature and cannot be regarded as legal advice. The author would be pleased to provide additional details and to discuss the possible application of these matters in specific situations.

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