

Canada Revenue Agency

Taxpayer Alert



Warning: Tax shelter gifting arrangements are risky

Taxpayers should be aware of the risks associated with participating in certain tax shelter gifting and donation arrangements, including gifting trust arrangements, leveraged cash donations, and buy-low, donate-high arrangements.

On April 20, 2006, the Supreme Court of Canada announced that it would not hear the taxpayers' appeals of the decisions of the Federal Court of Appeal (FCA) in the cases of Frank Klotz and Quinn, Tolley and Nash. These decisions involved buy-low, donate-high art flipping arrangements in which the taxpayers purchased artworks and donated them to charities. The charities issued donation receipts for three or four times the donors' costs, so that the tax refunds exceeded the costs to the donors. The FCA held that the value of the donations was limited to the amount of cash that the taxpayers paid for the artworks.

Despite these favourable court decisions for the Canada Revenue Agency (CRA), and despite proposed amendments to the *Income Tax Act* announced by the Department of Finance on December 5, 2003, some donation arrangements continue to be promoted. We have previously reminded taxpayers that the proposed amendments are applicable to years after 2003. They limit donations made under tax shelters and other arrangements to a maximum of the donor's out-of-pocket costs.

Audits

The CRA continually audits many gifting arrangements and has completed a number of such audits. For donations made prior to 2002, the CRA has reassessed about 6,700 taxpayers, disallowing about \$490 million in donations. For the 2002 tax year, a further 5,700 taxpayers, with donations of \$360 million, have just been audited and reassessments were issued in all arrangements. For the 2003 tax year, about 1,800 taxpayers have been audited to date with some \$66 million in donations disallowed. Generally, the CRA reduces the amount of the gift to no more than the cash paid by the taxpayer, and in many cases it is reduced to less than that. In some cases it is reduced to nil, when the donation is not a true gift.

The fact that investors in some of these tax shelter gifting arrangements have not been reassessed should not be interpreted as the CRA's acceptance of the arrangement. The CRA generally has three years from the date of assessment to reassess taxpayers and these audits can take over a year to complete.

Current tax shelter promotions

Some of the arrangements currently being marketed as donation programs and gifting initiatives are advertised and/or promoted as resulting in "unique" or "valuable" "tax saving opportunities". These are "gifting trust arrangements" and "leveraged cash donations." In

gifting trust arrangements, the taxpayer makes a cash donation to a charity and also becomes a beneficiary of a trust. The taxpayer receives property as a distribution from the trust and donates it to a charity. The taxpayer receives donation receipts for the total of the cash and the purported fair market value of the property. Typically, the total cash paid by the investor is about 30 percent of the amount on the donation receipts.

The proposed amendments to the *Income Tax Act* announced by the Department of Finance on December 5, 2003, provide that the donation amount on which the tax credit is based will be reduced by any “advantage” that is in any way related to the gift. It is the CRA's position that the receipt of such property from the trust is such an advantage, and the donation amount will be reduced accordingly.

In leveraged cash arrangements, a taxpayer receives a prearranged loan and makes a donation of the loan proceeds and additional cash to a charity. The taxpayer is not at risk for the loan and the charity must use the proceeds in a predetermined manner.

The definition of “advantage” for this purpose includes a limited-recourse debt in respect of the donation. A limited-recourse debt is broadly defined to include any unpaid amounts if there is a guarantee, security, or similar indemnity or covenant in respect of the debt. It is the CRA's position that debts incurred as part of a leveraged cash donation constitute limited-recourse debts if they are to be repaid under such arrangements structured as part of the donation arrangement. The donation amount will be reduced accordingly.

Tax Shelter Identification Numbers

The CRA reminds taxpayers that tax shelter numbers are used for **identification purposes only**. They do not guarantee that taxpayers are entitled to receive the proposed tax benefits. Rather, they enable the CRA to identify all tax shelters and their participants. The CRA reviews all tax shelters to ensure that the tax benefits being claimed meet the requirements of the *Income Tax Act*.

Previous Warnings

We have previously addressed this issue in a Taxpayer Alert issued in **November 2005**, and in Fact Sheets issued in **November 2003** and **November 2004**. These are all available at www.cra.gc.ca.