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Gift Low No-No

CRA wins on donation schemes

COURT REPORT

BY JAMIE GOLOMBEK

Last month, the Federal Court of Appeal dealt a blow to tax shelters when it handed down rulings on a trio of cases about tax shelters involving art deals.

The release of the three Federal Court of Appeal decisions coincidentally coincided with the Canada Revenue Agency's annual warning on certain tax shelters such as "gifting trust arrangements, leveraged cash donations, and buy-low, donate-high arrangements," which are often aggressively promoted during these last few weeks of the year.

These shelters frequently involve a donation of property, such as medical supplies or computer software, to a registered charity. According to one promoter, the donor gets a receipt "equal to the appraised fair market value of the property donated to the [charity]. The fair market value of the property has been substantiated by an independent appraisal. A donor may request a copy of this appraisal by contacting [the promoter]."

> But just because you have an independent appraisal doesn't mean that you're home free when it comes to defending the fair market value before the CRA.

But just because you have an independent appraisal doesn't mean that you're home free when it comes to defending the fair market value before the CRA. The CRA has been aggressively challenging, and winning, many of the tax shelter cases in the last few years on the basis of inflated valuations.

This has become such a hot topic that this past fall, David Chodikoff, the head of the tax litigation group at Goodman and Carr LLP in Toronto, delivered a paper at the 3rd Annual Valuation and Tax Practice course entitled "Valuation and Tax Shelters" put on by Federated Press.

The three tax decisions released last month by the Federal Court of Appeal were *Nash*, *Tolley* and *Quinn*. The basic facts of all three were similar and involved the donation of art to charity.

Each of these taxpayers purchased a number of limited edition prints through CVI Art Management, a promoter that they learned of through their financial advisors. Mr. Nash paid about $8,500 for about 85 signed and numbered prints. Ms. Tolley purchased 99 prints for just over $8,000 and Ms. Quinn purchase 48 prints for $8,600.

Mr. Nash and Ms. Tolley each kept one print, but the rest of them were donated to charity. In all three cases, each of the taxpayers, having paid between $8,000 and $8,600 for the prints, received tax receipts indicating a fair market value of greater than $20,000 each.

The CRA argued that the donation receipt should be restricted to lesser amounts: the amounts actually paid to purchase the prints, as this was indicative of fair market value.

At the lower court, the Tax Court of Canada judge dismissed the CRA's argument and agreed with the taxpayers' experts regarding the fair market value of the prints.

Last month, however, the Federal Court of Appeal reversed all three lower court decisions and ruled that the taxpayers were restricted to the amount they paid for the prints and disallowed the higher donation values.

> The current crop of shelters claim they are unaffected by these new proposed rules.

The Appeal Court said that the lower court made a "palpable and overriding" error in finding the "fair market value of property to be three times the amount paid for the property with no credible explanation for the apparent three-fold increase."

While these "buy-low, donate-high" types of tax shelters have been mostly, if not entirely, eliminated as result of new tax legislation introduced in December 2003, the current crop of shelters claim they are unaffected by these new proposed rules.

While this may indeed be true – you should ensure your clients receive independent tax and legal advice before investing in any of these – the trio of cases released last month demonstrate that the fair market value of property being donated is always an issue and may be aggressively attacked

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by the CRA if it feels that such a value is inflated.

According to Chodikoff, these new laws are "unlikely to put a halt to the donation tax shelter plans. Such shelters have an appeal and promoters will continue to exploit that interest to recruit participants... It is only when a sufficient number of taxpayers go to court and lose . . . then it is probable that we will not see these types of tax shelters again."

We may not have heard the end of these three cases though. In a letter dated Nov. 25, 2005 and sent to all participants in the CVI program, the law firm of Stikeman Elliot LLP, retained on behalf of CVI participants, informed them that "strong arguments could be made to persuade the Supreme Court of Canada to set aside the Federal Court of Appeal's decision . . . [I]n our respectful view the trial judge did not make any 'palpable and overriding error.'"

The letter concluded that Stikeman Elliot will be seeking leave to appeal these cases to the SCC. As there is no automatic right to appeal to the SCC, the Court must first grant leave to appeal. Since the SCC only grants leave in a few tax cases each year and only in matters of national importance, there is certainly no guarantee that they will agree to hear these cases. Stay tuned. **AER**

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More Level Playing Field for Dividends

BY MARK BROWN

After some heartache for investors, Ralph Goodale ended up leaving income trusts alone while cutting the tax on dividends. But while the markets responded dramatically the next morning, many advisors were still trying to make sense of the new changes. Will the change establish parity between corporations and income trusts? Does the minister's plan solve the problem with tax leakage? Does this make income trust conversions less attractive?

The short answer to all of those questions is no. That's not to say this was a bad move on Goodale's part. "This is a very, very good step in the right direction to equal the playing field," says Janet Ecker, executive director of the Toronto Financial Services Alliance, a public private initiative made up mostly of the big banks. But, she says "there are certainly many policy issues around income trusts that will require some thoughtful policy deliberation after the dust has settled after the election."

Under Goodale's plan, eligible dividends will be "grossed-up" to 45%, up from 25% and the dividend tax credit will be increased to 19% of the grossed-up dividend from 13.3%. The gross-up compensates the shareholder for the tax already paid by the corporation.

The effective tax rate for an individual on eligible dividends (i.e., excluding investment income or income subject to the small business rate) will be reduced so that at the top marginal tax rate, the taxpayer will pay about 21% on these dividends compared with 32% as it is now – that is, if the provinces come on side with their own tax changes. These rates are based on a combined average federal and provincial corporate tax rate of 32% in 2010 – the year in which the 2005 federal budget's corporate tax reductions will be fully implemented.

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The enhanced dividend tax credit will mean that the income threshold for paying tax on dividends will increase. As Ernst & Young points out in one of their recent *Tax Alerts*, in 2006 an individual in Ontario with taxable income from non-dividend sources of about $35,000 will not pay any tax on an additional $100