

## Charity Scams — What You and Your Clients Should Know

In the early 1990s, a commonly marketed tax shelter scheme involved using the 100% capital cost allowance (CCA) rate for computer software (Class 12). Promoters encouraged taxpayers to invest as limited partners, buying interests in software at inflated valuations, in part with “real money” and in part with limited recourse debt. The investors hoped to get tax deductions the value of which greatly exceeded their actual cash investments. The Department of Finance announced rules in 1997 to curb these tax shelter investments.

Starting in the late 1990s and early 2000s, promoters turned to charitable tax donations as a way to (try to) offer taxpayers enhanced tax deductions (credits) without relying on partnerships, CCA, or business losses, thereby avoiding the new rules that made the old software schemes ineffective. The new tax donation schemes did rely, though, on the same principle of artificially inflated value to enhance tax deductions, supplemented with donation leveraging by limited recourse or low interest debt. These are the gifting tax shelter schemes that have drawn extensive media coverage and thousands of reassessments. Some of these reassessed taxpayers may be your clients.

### The CRA's battle against charity scams

By October 30, 2012, the CRA reported that it had “to date denied more than \$5.5 billion in donation claims and reassessed over 167,000 taxpayers who participated in gifting tax shelter schemes. In addition, the CRA has revoked the charitable status of 44 charitable organizations

that participated in these gifting tax shelter schemes.” (See the CRA's webpage, [“The Canada Revenue Agency: protecting Canadians from gifting tax shelter schemes.”](#))

### 2013: new rules to crack down on charity scams

In the June 2013 1,000-page tax technical bill, Parliament added an array of rules, some effective as far back as 2002, designed to thwart these charity schemes. For example, new rules in ITA ss. 248(30)–(41) determine: (a) when an amount qualifies as a “gift” for tax credits; (b) the fair market value of a gift of property; and (c) the amount of the credit, in cases where the taxpayer gets a benefit back from the charity or where part of the gift is limited recourse debt. New s. 237.3 requires promoters and participants in tax “avoidance transactions” to file an information return on the transaction if the promoter earns a fee based on the amount of tax benefits or the number of participants or if participants are indemnified if the tax scheme fails.

Under newly amended s. 225.1(7), starting with assessments of the 2013 tax year, the CRA may immediately collect 50% of the amount assessed for a failed donation tax shelter. This is different from the normal income tax collection rule, which forbids the CRA from collecting until your client's objection and Tax Court appeals have been decided. And the CRA has said that, starting with the 2012 tax year, it will not issue initial assessments of tax returns with donation credit scheme claims until it has audited the tax shelter, “which may take up to two years”; thereby

delaying refunds and discouraging taxpayers from investing in the schemes.

### **Courts in support of the CRA disallowing the charity scams**

These new tax rules may not have been needed; even without them, the Courts have been supporting the CRA's reassessments disallowing the charity donation schemes. In 2010, in [\*Maréchaux v. Canada\*](#), the Federal Court of Appeal (FCA) said that gifts were invalid for tax credits if made in a leveraged charitable donation program with a substantial part of the purported gift funded by an interest-free loan provided by the promoters. And in December 2013, in [\*Kossov v. Canada 2013 FCA 283\*](#), the FCA said that an art donation scheme, in which the charity got only 0.5% of the money from "donors," also failed because the participants got "25 year interest-free loans" to make the scheme work. The FCA agreed with the TCC that the free loan was a benefit that invalidated the entire gift.

In earlier years, when the CRA was beginning the slow process of reassessing these schemes, it sometimes offered to allow those taxpayers who agreed to a reassessment to have a donation credit based on the amount of their actual cash outlay. In many of these schemes, the cash outlay might be 20% of the nominal "donation." (In Ms. Kossov's case, her total cash outlay was about 34% of the donation because it included a security deposit and a loan processing fee.) But with these FCA successes behind it, the CRA might not give your clients this option. In *Maréchaux* and *Kossov*, the taxpayers got nothing: the entire gift was void for tax-credit purposes. But because many of these reassessments involve thousands of taxpayers and can take years for test cases to work

through objections and Tax Court appeals, the CRA may allow some interest relief for the waiting period.

### **Your suggestion to clients — not worth it!**

Considering the risk and cost of failure, it's surprising that so many taxpayers took part in charity scams, given the rate of return on some of these "investments." For example, even if the scheme worked, Ms. Kossov only stood to get tax refunds equal to her cash outlay plus about 18%. That's not a great return for the risk taken, and she and others like her lost their initial cash outlay, which went mostly to promoter's fees, sales commissions, and legal defence funds. They also had to pay back the taxes they attempted to save, plus interest.

### **Check for class lawsuits if you have clients involved in charity scams**

If you have a client consult with you about the charity scams, there may not be much you can do if she or he has already been reassessed. For that reason, there have been many class actions against the lawyers and promoters. Top Canadian law firms lent their reputations to these schemes, assuring participants that, although, as with all tax plans, "the matter is not free from doubt," the donations would qualify for tax credits. Your clients should investigate whether they are already members of the classes or whether lawsuits involving their schemes are planned. For example, most of the 2,825 participants in the Banyan Tree Foundation Gift Program settled their class action against the national law firm Fraser Milner Casgrain for \$11 million.

#### **Disclaimer:**

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