

UNDUE BENEFIT: WHAT DOES IT MEAN IN PRACTICE?

James M. Parks  
Cassels Brock & Blackwell LLP  
Scotia Plaza, Suite 2100  
40 King Street West  
Toronto, Ontario M5H 3C2  
Tel: 416-869-5340  
Fax: 416-640-3053  
E-mail: [jparks@casselsbrock.com](mailto:jparks@casselsbrock.com)

## TABLE OF CONTENTS

<b>INTRODUCTION .....</b>	<b>1</b>
PENALTY FOR CONFERRAL OF UNDUE BENEFIT .....	1
DEFINITION.....	1
SUSPENSION.....	3
REVOCAION .....	5
<b>HISTORY.....</b>	<b>6</b>
JRT RECOMMENDATIONS .....	6
MARCH 2004 BUDGET .....	9
SEPTEMBER 2004 DRAFT LEGISLATION AND BILL C-33 .....	9
CAVEAT.....	10
<b>NOTICES OF OBJECTION AND APPEALS AND PAYMENTS TO ELIGIBLE DONEES .....</b>	<b>10</b>
<b>MEANING OF UNDUE.....</b>	<b>12</b>
<b>MEANING OF CONFERRED.....</b>	<b>22</b>
<b>DUE DILIGENCE DEFENCE.....</b>	<b>24</b>
<b>MEANING OF REASONABLE .....</b>	<b>25</b>
<b>MEANING OF ARM’S LENGTH.....</b>	<b>27</b>
<b>FIFTY PERCENT CONTRIBUTION TEST .....</b>	<b>31</b>
<b>INFLUENCE IN AN ARM’S LENGTH SITUATION WITHOUT SUBSTANTIAL CONTRIBUTIONS.....</b>	<b>32</b>
<b>POSSIBLE UNINTENDED RESULTS.....</b>	<b>34</b>
<b>TAXATION OF BENEFITS .....</b>	<b>37</b>
<b>QUANTIFICATION OF BENEFITS .....</b>	<b>40</b>
<b>SPECIFIC EXCLUSIONS.....</b>	<b>40</b>
<b>EXAMPLES .....</b>	<b>42</b>
<b>CRA’S ADMINISTRATIVE POSITION.....</b>	<b>46</b>
<b>MISCELLANEOUS .....</b>	<b>47</b>
<b>CONCLUSION .....</b>	<b>50</b>

## UNDUE BENEFIT: WHAT DOES IT MEAN IN PRACTICE?

### Introduction

#### Penalty for Conferral of Undue Benefit

Under subsection 188.1(4) of the *Income Tax Act*<sup>1</sup>, a registered charity is liable for a penalty if it confers an “undue benefit” on a person. The amount of the penalty is 105% of the amount of the benefit, unless there is a repeated infraction. Where there is a repeated infraction, and the Minister of National Revenue (the “Minister”) has previously assessed a penalty for conferring an undue benefit within the previous five years, or has previously assessed a penalty for a repeated infraction, the penalty is 110% of the amount of the benefit.

#### Definition

For this purpose, the circumstances in which an undue benefit is conferred on a person (I refer to this person as the “beneficiary”) by the registered charity include:

- (a) a disbursement by way of a gift;<sup>2</sup>
- (b) the amount of income,<sup>3</sup> rights, property or resources of the charity paid, payable, assigned or otherwise made available for the personal<sup>4</sup> benefit of

---

\*An earlier version of this paper was presented at the Fourth National Symposium on Charity Law of the National Charities and Not-for-Profit Law Section of the Canadian Bar Association in Toronto on May 11, 2006.

<sup>1</sup> RSC 1985, c.1 (5<sup>th</sup> Supp.), as amended (hereinafter referred to as the “Act”). Unless otherwise noted, statutory references herein are to the Act.

<sup>2</sup> The Act does not expressly define “gift”. Proposed new rules in the draft legislation introduced on July 18, 2005 are intended to “save” certain transfers that would not otherwise be gifts at common law, such as transfers where the donor receives an advantage. These situations are referred to as “split-receipting” situations.

<sup>3</sup> For this purpose, it is not clear if the definition of “income” applicable for purposes of section 149.1 will apply. Paragraph 149.1(12)(b) expressly includes gifts, other than enumerated gifts. Unlike the rules for not-for-profit organizations, there is no express exclusion for taxable capital gains or allowable capital losses, as in subsection 149(2). Although subsection 187.7 provides that the definitions in subsection 149.1(1) apply to Part V, which contains the intermediate sanctions, it does not appear to incorporate the

any person who is a proprietor, member, shareholder, trustee or settlor of the charity;

- (c) the amount of income, rights, property or resources of the charity paid, payable, assigned or otherwise made available for the personal benefit of any person who has contributed or otherwise paid into the charity more than 50% of its capital;<sup>5</sup>
- (d) the amount of income, rights, property or resources of the charity paid, payable, assigned or otherwise made available for the personal benefit of any person who deals not at arm's length<sup>6</sup> with such a person or with the charity;
- (e) any benefit conferred on a beneficiary by another person, at the direction or with the consent of the charity that would, if it were not conferred on the beneficiary, be an amount in respect of which the charity would have a right,<sup>7</sup>

---

meaning of income in paragraph 149.1(12)(b). Given the scope of the provision and the reference to "resources", this may not be significant.

<sup>4</sup> The inclusion of the word "personal" suggests that there may be benefits that are not personal and that thus do not give rise to a penalty. There is no indication of what is meant by "personal" as opposed to, for instance, non-personal benefit.

<sup>5</sup> It appears that this test is applied at the time the benefit is conferred, and will not apply if the beneficiary has at some point in the past contributed more than 50% of the capital but subsequently others have contributed more than 50%. This is in contrast to the proposed new definition of public foundation in the draft legislation introduced on July 18, 2005, which recognizes situations in which others may subsequently contribute more than a person who has initially contributed more than 50% of the capital. As discussed below, there is no concept of a non-arm's length group of contributors. As a result, there may be room for creative planning where one person is a contributor and another person receives a payment from the charity.

<sup>6</sup> Interestingly, the term used is "deals not at arm's length" rather than "does not deal at arm's length", which is the more common term in the Act.

<sup>7</sup> This appears to be an attempt to replicate the concept in subsection 56(2), which deals with the taxation of indirect benefits. This is discussed below. It appears to be an attempt to deal with constructive receipt, through which the charity would have received an amount but directs that it be paid to the beneficiary by a third party. This will raise interesting questions about the onus on Canada Revenue Agency ("CRA") to establish that the charity either directed the benefit or consented to it.

but an undue benefit conferred on a person will not include a disbursement or benefit to the extent that it is:

- (f) an amount that is reasonable consideration or remuneration for property acquired by or services rendered to the charity;<sup>8</sup>
- (g) a gift made, or benefit conferred, in the course of a charitable act in the ordinary course of the charitable activities carried on by the charity, unless it can reasonably be considered that the eligibility of the beneficiary for the benefit relates solely to the relationship of the beneficiary to the charity; or
- (h) a gift to a qualified donee.

There are three separate types of benefits included in the definition, namely a disbursement by way of gift (as in paragraph (a)), the income, etc. that is made available for the personal benefit of a particular person (a trustee or member, contributor, or a non-arm's length person) (as in paragraphs (b), (c) and (d)) and a benefit conferred by another person (as in paragraph (e)). On the other hand, the exclusions in paragraph (g) above are limited to gifts made or benefits conferred, and do not seem to include amounts paid to or made available for the personal benefit of a person.<sup>9</sup>

### Suspension

Under subsection 188.2(1) of the Act, the Minister is required to send a notice suspending the authority of the charity to issue official tax receipts for one year, if a penalty is assessed under paragraph 188.1(4)(b) for a repeat infraction in respect of an

---

<sup>8</sup> As discussed more fully below, it is interesting that the test is whether the amount itself is reasonable consideration or reasonable remuneration, and not whether the amount is reasonable in the circumstances. An amount may be reasonable in isolation but not reasonable in the overall circumstances.

<sup>9</sup> Perhaps the exclusion for a "benefit conferred" in the course of a charitable act in the ordinary course of the charitable activities is intended to include situations in which an amount is paid to a person out of income or other resources, as contemplated in (b), (c) and (d) above.

undue benefit, other than an undue benefit conferred by the charity by way of a gift.<sup>10</sup> A charity that receives a notice of suspension can file a notice of objection and then apply to the Tax Court of Canada for a postponement of the suspension.<sup>11</sup> The Tax Court can grant an application for postponement only if it would be just and equitable to do so.<sup>12</sup>

Loss of the ability to issue receipts will be catastrophic for any charity, even if it subsequently is able to have a penalty set aside and have the suspension lifted. An application for postponement cannot be made until a notice of objection has been filed against the suspension. While the suspension is in place, the charity is deemed for a period of one year, beginning seven days after the notice of suspension is mailed, not to be a donee to which gifts can be made entitling a donor to tax relief. Although the charity is not prohibited from continuing to receive gifts, it must, if offered a gift, before accepting it, inform the donor that it has received the notice of suspension and that no deduction or credit will be available if the gift is made while the suspension is in place and that the gift will not be considered to be a gift to a qualified donee. This will be important for both donors seeking relief for gifts to a registered charity, and other charities seeking to satisfy their disbursement quota requirements by making a gift to a qualified donee.

As a result, the intermediate sanction of suspension will be a serious blow to many registered charities if they require an ongoing source of funding from donors seeking tax relief or from other registered charities that support qualified donees.

---

<sup>10</sup> See note 2, *supra*, for comments on the meaning of “gift”. I understand CRA feels the split-receipting rules do not apply for purposes of section 149.1. This raises a number of questions for purposes of the proposed new grounds for revocation. See note 18 *infra*. It also raises questions about the disbursement quota and whether a transfer to another registered charity is a gift.

<sup>11</sup> Subsection 188.2(4).

<sup>12</sup> Subsection 188.2(5). I do not deal with the consequences of suspension, except to note that a charity cannot issue official receipts while its status is suspended. Subsections 188.2(2) and (3) deal with this. There are other circumstances that can result in suspension.

The suspension will arise only if the penalty for conferring an undue benefit is assessed within five years of a similar assessment for a similar benefit, or if there is a repeat infraction within five years for other offences.<sup>13</sup>

The Minister can also issue a notice suspending for one year the ability of a registered charity to issue receipts if the charity contravenes certain sections of the Act or it is reasonable to consider that it has acted in concert with another charity that is the subject of a suspension, to accept a gift or transfer of property on behalf of the other charity.<sup>14</sup>

### Revocation

The Minister can revoke the registration of a registered charity if it has made a gift<sup>15</sup> to another registered charity and it can reasonably be considered that one of the main purposes of making the gift was to unduly delay the expenditure of amounts on charitable activities, or can revoke the registration of the recipient charity, if it can reasonably be considered that by accepting the gift it acted in concert with the registered charity attempting to unduly delay the expenditure of amounts on charitable activities.<sup>16</sup> In addition, if a registered charity has made a gift to another registered charity and it may reasonably be considered that one of the main purposes for making the gift was to unduly delay the expenditure of amounts on charitable activities, each

---

<sup>13</sup> Subsection 188.2(1).

<sup>14</sup> Subsection 188.2(2). Contravention of any of sections 230 to 231.5, dealing mainly with books and records and information returns, can lead to suspension.

<sup>15</sup> See the discussion at note 2, *supra*, with respect to the meaning of gift. It seems that not every payment made by one registered charity to another will necessarily be a gift for this purpose. However, this will generally depend on the desire of the charity making the transfer to meet its disbursement quota or otherwise comply with expenditure requirements in the Act. While it is beyond the scope of this paper to deal with the requirements to meet the disbursement quota, generally a registered charity will be required to expend amounts on its own charitable activities or by way of gifts to qualified donees. As a result, payments that are not gifts may be disadvantageous to a registered charity that must count the payments in meeting its disbursement quota.

<sup>16</sup> Subsection 149(4.1).

charity is jointly and severally liable to a penalty equal to 110% of the fair market value of the property.<sup>17</sup>

Under subsection 168(1), the Minister can give notice of a proposal to revoke the registration of a charity if it ceases to comply with the requirements of the Act for its registration. Failure to devote all of its resources to its charitable activities (within the extended concept in the Act) would be grounds for revocation of registration of a charitable organization and the registration of a charitable foundation could be revoked if any part of its income is payable to or otherwise available for the personal benefit of a member, trustee or settlor. As discussed below, the JRT considered whether the power to revoke registration should be retained when intermediate sanctions were introduced as an alternative, and concluded that both remedies should remain available to the Minister.

Under proposals in the July 18, 2005 draft legislation, there will be grounds for revocation of registration if a registered charity makes a disbursement by way of a gift, other than a gift made in the course of charitable activities carried on by it or to a donee that is a qualified donee at the time of the gift.<sup>18</sup>

## **History**

### **JRT Recommendations**

These “intermediate sanctions” were added to the Act as a result of proposals first introduced by the Department of Finance on September 16, 2004. Other intermediate sanctions include penalties for carrying on business and penalties for providing incorrect information in official receipts. This approach was a result of the report of the joint regulatory table (“JRT”) of the voluntary sector initiative made to the Minister of Finance in March, 2003. That report included seventy-five recommendations, including

---

<sup>17</sup> Subsection 188.1(11).

<sup>18</sup> See for instance, proposed paragraph 149.1(4)(b.1), for private foundations. In *Bayit Lepletot v. The Queen* (unreported) Court File A-158-05 (FCA), March 28, 2006, a charity was found not to be carrying on its own activities in Israel when it transferred funds in to a rabbi there as its agent. The court held the alleged agency arrangement did not exist.

recommendations for the introduction of intermediate sanctions, which at that time were not contemplated in the Act. Previously, the only real sanction available to the Minister was revocation of registration, which in many cases was considered to be far too draconian, depending on the particular circumstances.<sup>19</sup>

In particular, the report recommended that:

- (a) assuming an adequate recourse system in the form recommended was in place<sup>20</sup>, suspension of qualified donee status should be introduced as an intermediate sanction, with a requirement that a charity so suspended be obliged to notify donors and other charities of its status prior to accepting any gift from them;
- (b) assuming an adequate recourse system in the form recommended was in place, suspension of tax-exempt status should be introduced as an intermediate sanction, with the tax being set at up to 5% of the charity's previous year's revenue from all sources, or up to 10% of this amount for repeated cases of non-compliance, plus up to 100% of the revenue obtained from activities in breach of the requirements of the Act;
- (c) financial penalties on individuals should not be introduced as an intermediate sanction at this time;
- (d) deregistration should remain the ultimate sanction available to the regulator, but the revocation tax should be reformed in accordance with the principles set out in the Ontario Law Reform Commission's Report on the Law of Charities.

---

<sup>19</sup> For instance, a charitable organization must devote all of its resources to its charitable activities and a charitable foundation must be constituted and operated exclusively for charitable purposes and no part of its income can be payable to or otherwise available for the personal benefit of any proprietor, member, shareholder, trustee or settlor. The provision of such a benefit would be grounds for revocation. See the definitions of charitable organization and charitable foundation in subsection 149.1(1).

<sup>20</sup> The JRT recommended that rights to contest intermediate sanctions should be added to the Act.

In its report, discussing the concept of intermediate sanctions in more detail, the JRT referred to its earlier interim report, in which it had identified three types of intermediate sanctions, namely:

1. suspension of the status of the charity as a qualified donee under the Act;
2. a financial penalty on the organization while it temporarily lost its tax exempt status, in an amount up to 5% of its revenue in the previous year for a first infraction and up to 10% for repeat infractions;
3. a financial penalty on individuals connected with a charity in certain circumstances, including obtaining an inappropriate benefit as a result of influence over the charity or approving expenditures the individuals know are not charitable. The interim report had suggested a penalty equal to the amount of the benefit or expenditure, plus an additional 25%.

In its final report, the JRT backed away from the concept of individual penalties and noted that intermediate sanctions imposed on charities serve two different purposes, acting as an inducement to comply and acting as a penalty. It said that as an inducement to comply with the provisions of the Act and regulations, sanctions should persuade organizations to comply and be avoided entirely by satisfying the regulatory authority that the charity had corrected a problem before a sanction would otherwise become effective. The report then went on to state that sanctions should involve a penalty in certain circumstances including repeated infractions, and reinforcement of a message that the charity must meet its legal requirements, where the harm inflicted on beneficiaries and public confidence in the sector cannot be undone and where charitable status has been abused to the private advantage of individuals or to the damage of the public treasury. The JRT noted in particular that in the course of its consultations, it received conflicting views on the advisability of imposing financial penalties on individuals who abuse a position of influence in a charity's affairs. For this reason, the JRT was not ready to recommend the introduction of financial penalties on individuals and noted that the consultations raised a number of unanswered questions.

It referred to the experience in the United States, where there has been difficulty implementing these types of sanctions against the provision of excess benefits.

### March 2004 Budget

In March 23, 2004 budget, the Minister of Finance referred to the report of the JRT, dealt at length with the proposals to reform the regulation of registered charities under the Act and stated that the proposed intermediate taxes and penalties would include, among other things:

Suspension of a registered charity's tax-receipting privileges for using donated funds other than for charitable purposes. This may include, for example, situations where a registered charity provides undue benefits to its trustees.

The budget papers dealing with intermediate taxes and penalties described the infraction as "undue personal benefit provided by a charity to any person. For example, a transfer to a person who does not deal at arm's length with the charity or who is the beneficiary of a transfer because of a special relationship with the donor or a charity."

### September 2004 Draft Legislation and Bill C-33

In this context, the Department of Finance introduced a wide-ranging set of proposals dealing with the regulation of registered charities in draft legislation on September 16, 2004 and subsequently in Bill C-33, effective for taxation years that began after March 22, 2004. In the explanatory notes introduced with the draft legislation and the Bill, the Department of Finance stated that the amount of an undue benefit could be conferred by the charity or received by the beneficiary from a third party, at the direction of or with the consent of the charity, if the charity otherwise would have had a right to receive that amount.

This is the context in which the current provisions in the Act dealing with undue benefits must be construed, applied, enforced and, where appropriate, contested.

## Caveat

In this paper, I do not deal with non-tax issues such as the fiduciary duties of the directors or trustees of a charity, conflicts of interest and provincial laws regulating charities.<sup>21</sup> In many situations, the very transaction that gives rise to the conferral of an undue benefit may result in a breach of trust under charity law and may arise as a result of a conflict of interest.<sup>22</sup> It will be important that directors and trustees in particular be aware of the charity law and other commercial law implications and not focus only on tax issues.

There are also technical issues about the constitutionality of some of the provisions in the Act to the extent that they may arguably infringe on the jurisdiction of the provinces. That discussion is far beyond the scope of this paper.

## **Notices of Objection and Appeals and Payments to Eligible Donees**

As is the case with other intermediate sanctions, these penalties are imposed by notice of assessment issued under subsection 189(7) and the charity is entitled to file a notice of objection and, if necessary, a notice of appeal in the Tax Court of Canada.<sup>23</sup> As an alternative to filing a notice of objection or notice of appeal, the charity that has been assessed a penalty has the option to transfer assets to another registered charity.<sup>24</sup> If

---

<sup>21</sup> For instance, in Ontario, the *Charities Accounting Act* and the *Charitable Gifts Act* will be relevant.

<sup>22</sup> For examples of situations in which the Public Guardian and Trustee in Ontario challenged excessive fundraising expenses see *Ontario (Public Guardian and Trustee) v. National Society of Abused Women and Children*, [2002] OJ No. 607 (SCJ) and *Ontario (Public Guardian and Trustee) v. AIDS Society for Children*, [2001], 39 ETR (2d) 96 (SCJ).

<sup>23</sup> Subsection 189(8), incorporating the provisions in Part I. The rules in Part I apply in respect of an amount assessed as a penalty and in respect of a notice of suspension as if the notice were a notice of assessment made under section 152 in Part 1. A notice of objection filed under Part I will not constitute a notice of objection under Part V and an issue that could have been the subject of a notice of objection referred to in subsection 168(4) cannot be the subject of an appeal to the Tax Court of Canada in accordance with the Part I procedures. See subsection 189(8.1). I do not deal with the procedural issues relating to notices of objections and appeals in this paper.

<sup>24</sup> Subsection 189(6.3). The definition of “eligible donee” is set out in subsection 188(2.1). In effect, the eligible donee must be dealing at arm’s length with the charity that wishes to avoid the penalty, and must not be in default itself. Technically, the test is applied by looking at the directors and trustees of each charity. More than 50% of the directors or trustees of the recipient must deal at arm’s length with each director or trustee of the transferor.

the liability for all intermediate sanction penalties exceeds \$1,000, the liability can be reduced by the amount of property transferred after the day on which the first notice of assessment assessing any of the penalties resulting in that liability was issued, to an eligible donee. The amount of the reduction is equal to the excess of the fair market value of the property so transferred, at the time of transfer, exceeds the total of any consideration given by the eligible donee and any reduction previously taken into account.<sup>25</sup>

This reflects the fact that funds are generally donated to charities for the general public good and as a policy matter, should remain in the charitable sector and not be seized for general government use, even where the charity is in default.

The costs incurred by a charity to contest an assessment for a penalty or a suspension of its ability to issue official receipts raise a further question. It is hoped that CRA will not treat these expenses as “administrative”, rather than as expenses incurred in the course of carrying on charitable activities, if the activity that gave rise to the penalty was clearly part of the charitable activities carried out by the charity, particularly if the issue relates to the reasonableness of an amount paid by the charity.<sup>26</sup>

If a notice of objection is filed, CRA is precluded from taking collection proceedings until the notice of objection process has been completed.<sup>27</sup>

---

<sup>25</sup> To the extent that a transfer or payments to another registered charity has an impact on the disbursement quota of the charity that has conferred the undue benefit, there will be no double count. Under subsection 149.1(1.1), a transfer that is made because of subsection 189(6.3) to reduce the liability for a penalty under Part V is deemed to be neither an amount expended on charitable activities nor a gift to a qualified donee. As a result, it will not be counted in meeting the disbursement quota.

<sup>26</sup> For a discussion of what I understand is CRA’s current administrative policy in assessing penalties as intermediate sanctions, including penalties for the conferral of undue benefits, see the discussion at the end of this paper under “CRA’s Administration Position”.

<sup>27</sup> Under subsection 189(8), Division J of Part I applies in respect of amounts assessed under Part V, which contains the rules dealing with intermediate sanctions. The rules also apply with respect to a notice of suspension as if the notice were a notice of assessment. A notice of suspension that is reconsidered or reassessed may be confirmed or vacated, but unlike an assessment, cannot be varied. Division J includes section 225.1, which restricts the ability of CRA to collect assessed amounts until after the “collection-commencement day”, which in the case of an amount assessed under section 188.1 (such as an amount assessed for conferral of an undue benefit), is one year after the day on which the notice of assessment is mailed. Where a notice of objection is filed, CRA is further prevented from collecting the

Notwithstanding the general rule that CRA is precluded from taking collection proceedings while an amount is contested, there is provision for a jeopardy order in extreme cases. This requires CRA to satisfy a judge on a motion that there are reasonable grounds to believe collection of the amount in issue would be jeopardized by a delay in collection. A taxpayer faced with a jeopardy order is able to attack the order by taking appropriate steps.<sup>28</sup>

### **Meaning of Undue**

Despite the definition of the term “undue benefit” it appears that there is no requirement to measure whether any benefit is in fact “undue”. Interestingly, the Department of Finance chose not to approach this issue by introducing a charging section, under which the liability would arise if a registered charity conferred a benefit that was undue and then defining what is meant by undue. By defining the term “undue benefit”, it has linked the two terms and created some potential for ambiguity. It seems clear that there can be benefits that are not undue and there can be undue benefits that, but for the definition, might not have been regarded as undue at common law. This leads to a discussion of the meaning of “undue” on its own, and the meaning of the new term “undue benefit”, as defined.

It seems evident that not every benefit is an “undue benefit”. It is not clear whether every specifically identified transaction or event, such as every disbursement by way of gift or every payment of any part of the income or use of any resources of a charity for the personal benefit of a member or trustee is automatically treated as “undue”, or whether there is a quantitative or qualitative test.

It seems from a literal interpretation that there will be an undue benefit if even a nominal amount such as \$1 were paid to a person in these circumstances. The charging section

---

amount or taking collection proceedings until 90 days after the day on which notice is mailed that CRA has confirmed or varied the assessment. Where an appeal is filed in the Tax Court of Canada, the period is further extended until the day of mailing of a copy of the decision of the court to the taxpayer or the day on which the taxpayer discontinues the appeal.

<sup>28</sup> Section 225.2.

clearly requires that the benefit conferred on the person be an “undue benefit” before there is any liability for a penalty. This raises the fairly obvious question about how one determines whether a benefit is undue in a particular set of circumstances.<sup>29</sup>

The preliminary question, of course, before deciding whether the benefit is undue is deciding whether there is a benefit at all. The situation is problematic because the concept of undue benefit is defined by way of inclusion rather than by way of exhaustion. This suggests that there are undue benefits that have not been enumerated in subsection 188.1(5). Although it is not clear, the term “undue benefit” is presumably synonymous with “benefit that is undue”.

The tax jurisprudence is replete with examples of situations in which conferred benefits are relevant. For instance, an employee will be required to include in income the value of “benefits of any kind whatever” received or enjoyed in respect of, in the course of, or by virtue of an office or employment, subject to enumerated exceptions.<sup>30</sup> Similarly, where a benefit is conferred on a shareholder of a corporation or on a person in contemplation of becoming a shareholder, by the corporation, again with certain enumerated exceptions, the amount or value of that benefit must be included in computing income of the shareholder.<sup>31</sup> Another instance of a taxable benefit occurs where a person confers a benefit, either directly or indirectly, by any means whatever on a taxpayer. In that situation, the amount of the benefit is, to the extent it is not otherwise included in the taxpayer’s income and would be included in income if the amount of the benefit were a payment made directly by the person to the taxpayer, if the taxpayer were a resident in Canada, must be included in computing the taxpayer’s income.<sup>32</sup>

---

<sup>29</sup> In the explanatory notes released with the September 16, 2004 draft legislation and Bill C-33, the Department of Finance stated that “generally” undue benefits will include those enumerated items listed in subsection 188.1(5). This seems to suggest that merely because the payment is a gift or is otherwise mentioned in the enumerated list of benefits, it will not necessarily be an undue benefit.

<sup>30</sup> Paragraph 6(1)(a).

<sup>31</sup> Subsection 15(1).

<sup>32</sup> Subsection 246(1). There is an exclusion where it is established that the transaction was entered into by persons dealing at arm’s length, *bona fide* and not pursuant to or as part of any other transaction and

A payment made pursuant to the direction of or with the concurrence of a taxpayer to another person for the benefit of the taxpayer or as a benefit that the taxpayer desired to have conferred on the other person will be included in computing the income of the taxpayer, to the extent it would be if the payment had been made to the taxpayer.<sup>33</sup>

The courts will likely have little difficulty in determining whether a benefit has been conferred on a person. The more difficult question will be whether an “undue benefit” has been conferred on a person within the meaning in subsection 188.1(4).

The word “undue” has been defined as “excessive or unwarranted”.<sup>34</sup> In a leading decision not dealing with income tax or charities<sup>35</sup>, the Federal Court of Appeal dealt with the meaning of an undue obstacle for purposes of the *National Transportation Act*, in deciding whether a railway tariff providing that an attendant who was capable of providing assistance to disabled persons could travel free was an undue obstacle to mobility of persons with disabilities because the railway was responsible for the boarding and deboarding of passengers. One of the issues was whether there was an “undue obstacle”. While the court decided the case based on the particular legislation and fact situation before it, it dealt with the meaning of “undue”.

The court stated that

“While there seems to be no jurisprudence dealing with what constitutes an undue obstacle to the mobility of disabled persons, the Courts have

---

to effect payment, in whole or in part, of an existing or future obligation. As discussed below, this raises a fundamental question as to whether persons are dealing at arm’s length with each other.

<sup>33</sup> Subsection 56(2). This provision has been the subject of much litigation and criteria have been established by the courts for its application. This concept seems to have been imported into the fifth express inclusion in the definition of undue benefit, which deals with benefits conferred on one person by another, at the direction of or with the consent of a charity, to the extent that it would otherwise be a right of the charity. It will be interesting to see whether the jurisprudence dealing with subsection 56(2) is relevant in interpreting this provision. For a discussion of the criteria to be used in applying subsection 56(2), see *Williams v. The Queen*, 2005 DTC 83 (TCC).

<sup>34</sup> Black’s Law Dictionary, 7<sup>th</sup> Edition, 1999, p. 1529.

<sup>35</sup> *VIA Rail Canada Inc. v. Canada (National Transportation Agency)*, 193 DLR (4<sup>th</sup>) 357 (SCC). Leave to appeal to the Supreme Court of Canada granted November 17, 2005 on other issues.

had ample opportunity to consider the use and interpretation of the word “undue” in other legislative contexts.

While “undue” is a word of common usage which does not have a precise technical meaning the Supreme Court has variously defined “undue” to mean “improper, inordinate, excessive or oppressive” or to express “a notion of seriousness or significance.” To this list of synonyms, the Concise Oxford Dictionary adds “disproportionate”.

What is clear from all of these terms is that “undueness” is a relative concept. I agree with the position expressed by Cartwright J., as he then was:

“Undue” and “unduly” are not absolute terms whose meaning is self-evident. Their use presupposes the existence of a rule or standard defining what is “due”. Their interpretation does not appear to me to be assisted by substituting the adjectives “improper”, “inordinate”, “excessive”, “oppressive” or “wrong”, or the corresponding adverbs, in the absence of a statement as to what, in this connection, is proper, ordinate, permissible or right.

The proper approach to determining if something is “undue”, then, is a contextual one. “Undueness” must be defined in light of the aim of the relevant enactment. It can be useful to assess the consequences or effect if the undue is thing allowed to remain in place.

Jurisprudence dealing with other provisions in the Act will also be relevant. In *Novopharm*<sup>36</sup>, the court dealt with former subsection 245(1) of the Act, which provided that no deduction was allowed in respect of a disbursement or expense made or incurred in respect of a transaction or operation that, if allowed, would unduly or artificially reduce income. That provision has since been repealed and replaced by the

---

<sup>36</sup> *Novopharm Limited v. The Queen*, 2003 DTC 519 (FCA).

general anti-avoidance rule (“GAAR”), but there is a body of law dealing with its interpretation and *Novopharm* is the most recent. In *Novopharm*, the court faced two competing approaches to the interpretation of former subsection 245(1), and in particular the scope to be given to the concept of “unduly or artificially”. The Tax Court followed an earlier decision, holding that no deduction could be treated as unduly or artificially reducing income if there was a specific provision in the Act authorizing it. The Federal Court of Appeal rejected that approach and found that the deductions claimed should be disallowed, because they would have artificially reduced income. It found that a cleverly contrived series of pre-ordained transactions did not produce the desired tax result and the deduction was artificial because there was a combination of the pre-ordination of the transactions, circularity and limited amount of time during which they were all completed that took them out of normal business practice and rendered the deduction claimed artificial in the circumstances.

The court did not expressly deal with whether the deduction would also have been disallowed on the basis that it would have unduly reduced income. The court emphasized that the deduction claimed, if allowed, would be contrary to the object and spirit of the Act and the expense in question had not been made in accordance with the taxpayer’s normal business practice or entered into for *bona fide* business purposes. The court noted that the Supreme Court had earlier held that the jurisprudence in the lower courts was divided and there were conflicting opinions on the relevance of the presence of a *bona fide* business purpose. However, the Supreme Court has not pronounced definitively on the issue.<sup>37</sup> The Supreme Court found that it was not necessary to determine conclusively the proper interpretation to be given to subsection 245(1), since it had subsequently been repealed and replaced by the GAAR.

In *Novopharm*, the court stated that “if the Minister alleged an interest deduction unduly reduced income because the interest rate was excessive, it would be necessary to have regard to market rates of interest at the relevant time and the reasons why the interest rate paid was as high as it was. If only the interest payment transaction was considered

---

<sup>37</sup> See *Shell Canada v. The Queen*, 99 DTC 5669 (SCC).

and market rates and other considerations were ignored, a finding of undue could never be made. By the same token, when it is contended by the Minister that a deduction artificially reduces income, it is necessary to have regard to all the relevant circumstances and, in particular, to the series of transactions related to the transaction in respect of which the interest expense is incurred.” As a result, the court clearly distinguished between something that is undue and something that is artificial.

*Novopharm* is authority for the proposition that if the Minister alleges that a benefit is undue, it will be necessary to have regard to surrounding circumstances. As stated by the Supreme Court in *Via Rail*, “undue” is not an absolute term with a self-evident meaning and there is a presupposition that there is a rule or standard defining what is due as opposed what is undue”. This suggests that some benefits are clearly due and others are “undue”. The difficulty is in applying the test.

In *Mara*,<sup>38</sup> the Supreme Court of Canada reversed the Federal Court of Appeal, restoring the decision of the Tax Court and following the dissenting decision in the Federal Court. The Supreme Court agreed with the conclusion reached by the Tax Court and the dissenting judge in the Federal Court of Appeal, without expressly stating that it agreed with all of the reasoning. The Tax Court referred to the decision of the Federal Court of Appeal in *Spur Oil*<sup>39</sup>, which stated that “undue” when used in the context of subsection 245(1) should be given its dictionary meaning of “excessive”.<sup>40</sup>

The concept of “undue” appears in a number of provisions in the Act and has been addressed by CRA in a number of its administrative policies. For instance, the “fairness package” deals with “undue hardship”.<sup>41</sup> Similarly, the Act contemplates reductions in

---

<sup>38</sup> *Mara Properties Ltd. v. The Queen*, 96 DTC 6309 (SCC).

<sup>39</sup> *Spur Oil Ltd. v. The Queen*, 81 DTC 5188 (FCA).

<sup>40</sup> In *Don Fell Ltd. v. The Queen*, 81 DTC 5282 (FCTD), it was held that the word unduly relates to quantum and means “excessively” or “unreasonably”. This seems to extend the scope of the word beyond what was contemplated in *Spur Oil*.

<sup>41</sup> Subsection 221(4.7).

the amounts required to be withheld by employers at source in appropriate circumstances such as undue hardship.<sup>42</sup>

Under subparagraph 40(2)(g)(ii) of the Act, a capital loss can be denied in certain circumstances. CRA has issued interpretation bulletin IT-239R2, outlining its administrative position on when a loss might nevertheless be allowed, despite the fact there is no clear income-earning potential on a loan that has gone bad. In a typical situation, a taxpayer makes an interest-free loan to a corporation in which he or she was a shareholder, the loan becomes bad and a capital loss is claimed. Technically, there is a question whether the loan was made to earn income, since the immediate use of the money that was lent was not to earn interest. The courts have agreed with CRA's administrative policy, which generally recognizes that income earned indirectly, such as through management fees or dividends, would support an income-earning purpose. CRA states in the bulletin that where a taxpayer has lent money at less than a reasonable rate of interest to a Canadian corporation of which the taxpayer is a shareholder, a subsequent loss from the inability to recover on the loan may be deductible despite the absence of a reasonable rate of interest if certain criteria are met. One of those criteria is that the "loan from the shareholder to the corporation at less than a reasonable rate of interest (or at no interest) does not result in any undue tax advantage to either the shareholder or the corporation".

This administrative approach clearly illustrates the difficulty in trying to determine in advance whether a particular situation results in hardship, an advantage or any other thing that is "undue" including a benefit conferred by a registered charity on a person for purposes of subsection 188.1(4). Clearly, beauty will be in the eye of the beholder and what some might consider to be undue might be regarded by others as not being undue. This will be particularly so if the test is something as ambiguous as "excessive" or "unwarranted". The modern approach to statutory interpretation requires a review of

---

<sup>42</sup> Subsection 153(1.1).

the context in which the provision has been implemented, as well as other considerations.<sup>43</sup>

In dealing with a situation involving a request by an organization for confirmation that it would be regarded as exempt from tax as a not-for-profit organization within the meaning in paragraph 149(1)(l), CRA stated that the mere earning of investment income would not in and of itself deny the exempt status but if the organization accumulated income to create a surplus fund, it might not be exempt. Although the document itself did not use the words “undue accumulation of surplus”, the summary did use those words.<sup>44</sup>

The courts have dealt with the term “undue tax benefit” in some cases. For instance, in *Fredette*<sup>45</sup>, the court considered GAAR where a rental property was acquired and held through a tiered partnership structure. In its reasons, the Tax Court stated that it was not necessary to apply GAAR to certain aspects of the transactions “in order to deny the undue tax benefit” claimed by the taxpayer. The court did not elaborate on what was meant by “undue tax benefit”.

The Federal Court of Appeal recently dealt with a situation in which a taxpayer was alleged to have improperly claimed a credit for a donation to a qualified donee.<sup>46</sup> This case dealt with one of many taxpayers assessed for having participated in a fraudulent scheme, claiming credit for donations that were not in fact made. In virtually all other cases, the tax credits were disallowed. In this situation, the taxpayer had been told by

---

<sup>43</sup> For instance, the Supreme Court of Canada recently pronounced on the interpretation of the GAAR in *The Queen v. Canada Trustco Mortgage Company*, 2005 DTC 5523 (SCC) and its companion case, *Mathew v. The Queen* (sub nom. *Kaulius v. The Queen*), 2005 DTC 5538 (SCC).

<sup>44</sup> CRA document no. 2002-0180335, October 20, 2003. This illustrates the ease with which ambiguous words such as “undue” can be used rather loosely by CRA and others to convey the impression that something is vaguely inappropriate because it is “undue”, without being specific. In the case of paragraph 149(1)(l), there are no guidelines on what would be an “undue” accumulation of funds. The term is not used in the Act and has developed as a result of CRA administrative practice and some jurisprudence. See, for instance, *The Canadian Bar Insurance Association v. The Queen*, 99 DTC 653 (TCC).

<sup>45</sup> *Fredette v. The Queen*, 2001 DTC 621 (TCC).

<sup>46</sup> *The Queen v. Doubinin*, 2005 DTC 5624 (FCA).

his financial planner that if he donated about \$7,000 to a registered charity, he would receive a charitable donation receipt for approximately \$27,500, if a non-resident trust made a charitable donation to the registered charity on his behalf equal to three times the amount of his donation. The registered charity informed him that the non-resident charity had made its donation and the taxpayer was therefore induced to make his own donation, and was given an official receipt entitling him to claim a credit for a much larger donation. The Tax Court held that even if the Canadian charity in question had been part of a fraudulent tax shelter scheme, the taxpayer was not in any way involved in the scheme, had a charitable intent to make a donation, and did not have any expectation of receiving a material benefit, because the suggestion that a non-resident trust would make a corresponding but larger donation to the organization was nothing more than a mere possibility. This was upheld on appeal.

The Crown argued that the taxpayer had hoped to qualify for a tax credit that was not justified and thus the credit was inappropriate. It argued, based on the decision in *Friedberg*<sup>47</sup>, that the taxpayer had received benefit because he had been given an “inflated tax receipt”. The court stated that it was impossible for the taxpayer to benefit from an inflated tax credit on the specific facts of the case, because even if the non-resident trust had made the donation, the Canadian charity could not have validly issued a charitable receipt to the taxpayer for the amount donated by the non-resident trust. As a result, the court held that the taxpayer had not received any actual benefit from an inflated tax receipt and in fact he might well have been described as having received a burden. If he had not received the receipt, he would not have experienced the difficulty he later faced in claiming a tax credit and being subjected to a reassessment and an appeal to the Tax Court and beyond.

*Doubinin* confirms that economic benefits, even when received as a result of a transaction with a charity, will not necessarily always be regarded as having the quality alleged by the Crown. This reasoning would appear to be relevant in analyzing

---

<sup>47</sup> *The Queen v. Freidberg*, 92 DTC 6031 (FCA). This case is authority for the proposition that merely receiving tax relief through a credit when making a charitable donation does not disqualify a taxpayer from treating the donation as a gift.

circumstances in which some form of economic benefit received from a registered charity might not necessarily constitute an undue benefit for purposes of subsection 188.1(4).

On the other hand, it has been held that in similar circumstances, there is an undue tax benefit. For instance, in *Abouantoun*<sup>48</sup>, alleged gifts to a charity were made and official receipts were obtained. The court found that the receipts were fraudulent and no gifts had been made. In distinguishing other cases, the court stated that there was a “mock” donation and although the taxpayer claimed that cash was donated, it was really the price paid to purchase a false receipt through which an “undue tax benefit” could be obtained. The court noted that the “undue benefit” could offer a return of more than 200% of the amount paid to purchase the false receipt.

In *Younes*<sup>49</sup>, there were five taxpayers, all of whom dealt with the same organization as in *Abouantoun*. Four taxpayers were unsuccessful, but the fifth succeeded because the Minister failed to prove on a balance of probabilities that he had purchased a false receipt. The same judge as in *Abouantoun* heard the case. In finding that the other four taxpayers were not entitled to credits, the judge found that all that occurred was the purchase and sale of a piece of paper which was to secure for the taxpayers a fraudulent, or “at least undue, tax benefit”.

While these cases do not provide any enlightenment on how one interprets what is meant by undue benefit or undue tax benefit, they illustrate that a court will clearly find there is such a benefit in appropriate circumstances. The charitable receipt cases are rather extreme, and although they dealt with the perspective of the taxpayer claiming a credit for a fictitious donation, it seems likely that courts in future will apply similar reasoning in determining whether a charity has conferred an undue benefit on a taxpayer for purposes of the penalty in subsection 188.1(4).

---

<sup>48</sup> *Abouantoun v. The Queen*, 2002 DTC 3811 (TCC).

<sup>49</sup> *Younes v. The Queen*, 2003 DTC 547 (TCC).

### **Meaning of Conferred**

Subsection 188.1(4) is a charging section. There can be no penalty unless all of the pre-requisites are met. The basic requirement is that the charity must be one that “confers on a person” an undue benefit. As a result, if no benefit is conferred, there can be no liability for a penalty. In this regard, the same drafting issue arises as in the case of the meaning of “undue benefit”. Rather than providing that a charity confers a benefit and that the benefit is undue, subsection 188.1(5) states that an “undue benefit conferred” on a person arises in the enumerated circumstances, which I have discussed above. This seems to be an indirect attempt to define not only “undue” but also “conferred”, for purposes of the charging section. This may have been intended to avoid having to establish that a benefit is actually conferred on a person and that the benefit is undue, if certain objective circumstances are present and having to establish that the charity is deemed to have conferred an undue benefit on that person in a particular capacity.

Otherwise (and perhaps in any event), there seem to be questions about whether a benefit is always conferred merely because a certain set of circumstances is present. For instance, there is considerable jurisprudence dealing with the conferral of benefits by a corporation on a shareholder for purposes of subsection 15(1). That provision applies where a benefit is conferred on a shareholder or on a person in contemplation of the person becoming a shareholder, by a corporation, subject to enumerated exceptions. It has been held that the word “confer” means “grant” or “bestow”.<sup>50</sup> In *Pillsbury*, based on the wording in the provision as it then was, the court held that even where a corporation has resolved formally to give a special privilege or status to shareholders, it is a question of fact whether the purpose was to confer a benefit or advantage on the shareholders or some purpose having to do with the business of the corporation, such as inducing the shareholders to patronize the corporation. It also held that it was equally a question of fact in each case where CRA contends that what appears to be an ordinary transaction between a corporation and a shareholder is not

---

<sup>50</sup> *MNR v. Pillsbury Holdings Ltd.*, 64 DTC 5184 (Ex. Ct.).

what it appears to be, but is in reality a method, arrangement or device for conferring a benefit or advantage on the shareholder *qua* shareholder. There have been a number of cases, with conflicting results, in which a shareholder has taken money from a corporation mistakenly thinking there was a balance in a loan account with the corporation. There have also been situations involving transactions between shareholders and corporations based on faulty valuations, where the corporation received too little by way of consideration for an asset transferred to a shareholder or the corporation paid too much to a shareholder for an asset acquired from the shareholder. These situations are not unlike some that will arise involving charities in transactions with members or directors or significant contributors, which might give rise to conferred undue benefits.

The courts have held that for purposes of subsection 15(1), a determination must be made as to whether a benefit has been conferred on a person in the capacity of shareholder.<sup>51</sup> A benefit can be conferred for purposes of subsection 15(1) without any intent or actual knowledge on the part of the shareholder or the corporation, if the shareholder or corporation should have known that a benefit was conferred and did nothing to reverse the benefit if it was unintended. Relativity is a factor, and where an error is alleged in bookkeeping, with the result that a shareholder was not aware an account had been overdrawn, negligence or wilful blindness will not be of any assistance. Shareholders should not be encouraged to see how “close they can sail to the wind” for this purpose and then plead relief on the basis that no intention or knowledge has been proven by CRA.<sup>52</sup> This concept may be relevant in determining whether there is a “conferred undue benefit” merely because of an objective fact situation, or whether there is any requirement that a benefit be conferred on a person *qua* member, director or contributor. As noted above, an undue benefit conferred on a person includes certain disbursements to or for the personal benefit of any person who is a member, shareholder, trustee or settlor of the charity or who has contributed or

---

<sup>51</sup> See, for instance, *Strachan v. The Queen*, 2000 DTC 2308 (TCC) and *Sheff v. The Queen*, 2003 DTC 1120 (TCC) and *Chopp v. The Queen*, 98 DTC 6014 (FCA).

<sup>52</sup> *The Queen v. Chopp*, 95 DTC 517 (TCC), affirmed 98 DTC 6014 (FCA).

otherwise paid the charity more than 50% of its capital or who deals not at arm's length with such a person or with the charity. It seems to be implicit that the same issue of "capacity", linking the conferral of the benefit by the charity and the person, which is necessary between a corporation and its shareholder for purposes of subsection 15(1), is also relevant here. Thus, it seems that if there is no intention on the part of a charity to confer a benefit, despite the fact that an economic advantage is received by a member or director or a significant contributor, a defence may be available in the same way that a defence is available to a person who happens to be a shareholder, on whom a benefit is technically conferred for purposes of subsection 15(1).

### **Due Diligence Defence**

The courts have recently made it clear that despite what appears to strict liability for certain penalties, a taxpayer can establish a due diligence defence in some cases. This jurisprudence originated in commodity tax cases but has now evolved into the realm of income tax and the Act.<sup>53</sup> When a taxpayer wishes to avoid a penalty on the basis that sufficient due diligence has been conducted, the issue becomes one of whether the taxpayer can positively prove that all reasonable care was exercised to ensure no errors were made. A taxpayer is expected to comply with the requirements of the Act with a high degree of diligence, using the sources of information, facilities and resources available to that taxpayer. Frequently, when the due diligence defence is pleaded, the court finds that a high degree of conduct is not present and the penalty is not set aside. Nevertheless, the defence does remain available and in appropriate circumstances charities may be able to invoke it to avoid liability for a penalty for having conferred an undue benefit or perhaps convince a court that no undue benefit has been conferred.

This might be of assistance, for instance, if a charity and one of its members or directors, rely on third party opinions and appraisals, but subsequently are alleged to have entered into a transaction in the course of which the charity received too little consideration for the transfer of an asset to the person or the person received too much

---

<sup>53</sup> *Pillar Oilfield Projects Ltd. v. The Queen*, 1993 GSTC 49 (TCC), adopted in *Ogden Palladium Services (Canada) Inc., et al v. The Queen*, 2001 DTC 345 (TCC).

consideration from the charity for the transfer of an asset to the charity. In either case, a benefit would be conferred and it appears that this is the type of situation which income would be assessed against the person as a shareholder as contemplated in subsection 15(1). However, where the issue is whether the charity is liable for a penalty because it conferred a benefit (on the assumption that the benefit is conferred for purposes of subsection 188.1(4) and the deeming provisions in subsection (5)), it seems it would be appropriate for the charity to be able to rely on the defence of due diligence if there was nothing further that it could have done to try to avoid the unintended result. It remains to be seen whether the courts will be sympathetic in cases such as this if CRA itself is not prepared to take a lenient approach, at least in unclear instances and particularly where the charity has had a good track record and has clearly attempted to comply with the Act and regulations.

### **Meaning of Reasonable**

An important exclusion in paragraph 188.1(5)(a) from an undue benefit conferred on a person is available where an amount is “reasonable consideration or remuneration” for property acquired by or services rendered to the charity. It is not clear whether this is also intended to address the converse situation, in which the charity itself supplies the property or services to the person who is alleged to receive the benefit. It seems clear that if a charity purchases an asset or receives a service from a director or member, it will be necessary to establish that the charity does not pay more than a reasonable amount. However, it is not clear that the same exclusion will apply if the charity sells the asset to the other person or supplies the services to the other person, who pays inadequate consideration.

In any event, the question is whether the consideration or remuneration is “reasonable”. It seems that the test should be based on the consideration for property acquired by the charity or services rendered to the charity, and not on the overall circumstances. Thus, there should be determination of whether a particular acquisition of property or services occurs in exchange for a “reasonable” amount of consideration or remuneration. Whether an amount is reasonable will obviously be a question of fact. Whether a court will be persuaded by CRA that it can look at all of the overall circumstances, rather than

the particular transaction at issue, remains to be seen. As discussed below, there may be situations in which the purchase of one asset by a charity from a director or member is reasonable at a stipulated price, but a purchase of a ten year supply of the same asset might not be reasonable in the circumstances, because the charity would never be able to use all of the assets, even though the price paid might be objectively reasonable on per-item basis.<sup>54</sup>

It has been held that in determining whether an expenditure is reasonable in the circumstances, and thus deductible in computing income, it is not a question for the Minister of National Revenue or the court substituting its judgment for what is a reasonable amount to pay, but rather a case of the Minister or the court coming to the conclusion that no reasonable business person would have contracted to pay that amount having only the business consideration of the taxpayer in mind.<sup>55</sup>

There is a considerable body of jurisprudence on the meaning of “reasonable” in various contexts. For instance, a number of provisions in the Act require a determination of whether it is “reasonable to consider” that a certain set of circumstances is present.<sup>56</sup>

It appears that the most that can be said in the abstract is that a court will review the surrounding circumstances and, in determining whether a particular amount is

---

<sup>54</sup> CRA has the option to revoke the registration of a charitable organization if it does not devote all of its resources to its charitable activities or to revoke the registration of a charitable foundation if it does not continue to be organized and operated exclusively for charitable purposes. Expenditure of significant amounts on goods or services that are not immediately necessary or that will not be used in the foreseeable future could perhaps be regarded as violating these requirements, leading to revocation.

<sup>55</sup> *Gabco Ltd. v. MNR*, 68 DTC 5210 (Ex. Ct.), affirmed in *Safety Boss Limited v. The Queen*, 2000 DTC 1767 (TCC).

<sup>56</sup> See, for instance, *Tsiantoulas v. Canada*, followed in *Maege v. The Queen* (unreported), File No. 2002-2332 (IT) G (TCC), April 28, 2006, in which it was confirmed that reasonableness is a question of fact and requires the application of a measure of judgment and common sense. See also *Tedco Apparel Management Services Inc. v. MNR*, 91 DTC 1413 (TCC), following *The Queen v. Matador Inc.*, 80 DTC 6018 (FCA) on this point.

Cases decided under the former version of the Act dealing with the cost of depreciable property also considered the concept of reasonable consideration. See, for instance, *The Queen v. Waldorf Hotel* (1958) Ltd., 75 DTC 5109 (FCTD).

reasonable consideration or reasonable remuneration, likely take into account the context in which the determination must be made and the fact that a charity is seeking relief from a penalty that might otherwise be payable, but for the exclusion.

In the absence of any other jurisprudence directly on point, it seems logical to expect that decisions in litigation involving the exclusion from a conferred undue benefit will be based on jurisprudence dealing with other provisions in the Act and which the concept of reasonableness has been considered. In cases involving commercial issues, the taxpayer has generally argued that an amount is reasonable in the circumstances, and thus not disallowed, if it makes sense in a commercial context.<sup>57</sup> For purposes of the penalty for conferring an undue benefit, a charity will be required to argue that the amount paid as consideration for property acquired or as remuneration for services received is reasonable, without any clear context. The courts will take into account the policy behind the rules imposing intermediate sanctions, namely, to deter undesirable conduct, and determine whether an exclusion from liability is warranted based on an argument that a particular amount of consideration or a particular amount of remuneration is reasonable for that purpose.

### **Meaning of Arm's Length**

The liability for a penalty arises where an amount of income, rights, property or resources of the charity is paid, payable, assigned or otherwise made available for the personal benefit of any person who “deals not at arm’s length” with a beneficiary or with the charity. Presumably a person who “deals not at arm’s length” is no different from a person who “does not deal at arm’s length”, although it is interesting that the Department Finance has chosen to use different wording.

---

<sup>57</sup> For instance, under section 67, in computing income, no deduction is available in respect of an outlay or expense, except to the extent that it was “reasonable in the circumstances”. In *Stewart v. The Queen*, 2002 DTC 6983 (SCC), the Supreme Court held that if in the circumstances, an expense is unreasonable in relation to the source of income, section 67 provides a mechanism to reduce or eliminate the expense. Under paragraph 20(1)(c), a deduction is available for interest, assuming other criteria are met, to the extent of the lesser of the amount otherwise deductible and “a reasonable amount in respect thereof”.

The term non-arm's length is defined.<sup>58</sup> Related persons are deemed not to deal with each at arm's length. There are specific rules where a taxpayer and a "personal trust" are involved. Where the "related" test does not apply and there is no personal trust, it is a question of fact whether persons are dealing with each other at arm's length at a particular time. The usual tests based on relatedness will apply where the person to whom an amount is paid or payable or is made available for personal benefit does not deal at arm's length with the person on whom the benefit is conferred. This results in some circularity and suggests there is a difference between the person for whom the benefit is conferred (the beneficiary), and the person who actually receives the benefit. For instance, if a director of a charity causes it to make a payment to her spouse, she will be the beneficiary on whom the benefit is conferred, notwithstanding that the payment is actually made to the spouse. The situation becomes more difficult where the person receiving the actual payment is not related but may be not dealing at arm's length with the person who causes the payment to be made. For instance, a director of a charity may cause a payment to be made to a friend or business associate. If they are not dealing at arm's length, the payment will be an undue benefit, unless it is excluded because reasonable consideration was received in exchange, or one of the other exclusions is applicable. Similarly, where the benefit is conferred on the beneficiary at the direction of the charity by a third party, there will be an undue benefit. This situation could arise where the charity causes a customer to make a payment or otherwise directs an amount that would be its property to be paid to the beneficiary. The application of this rule could involve some difficulty in contrived situations, and as noted above, jurisprudence dealing with benefits conferred under subsection 56(2) may be relevant.<sup>59</sup>

---

<sup>58</sup> Section 251.

<sup>59</sup> Jurisprudence under section 246 and its predecessor may also be relevant. One might have thought that a charity to whom an amount is owing by a third party would have made a payment itself to the beneficiary by effectively assigning its entitlement to that amount. However, the express inclusion of directed benefits appears to be designed to avoid arguments about constructive receipt and other legal niceties.

The rules dealing with “relatedness” will generally not be applicable to determine whether a person deals at arm’s length with a charity. This will thus be a question of fact. As a result, there will often be considerable uncertainty in determining whether a particular person is or is not dealing at arm’s length with a charity, particularly where there have been close relationships. There is a large body of case law dealing with the concept of arm’s length. CRA has issued a summary policy statement.<sup>60</sup> CRA has set out its views more extensively in interpretation bulletin IT-419R2. This reflects the relevant jurisprudence, and states that in providing general criteria to determine whether persons deal at arm’s length, it must be recognized that all-encompassing guidelines to cover every situation cannot be supplied and each transaction or series of transactions must be examined on its own merits. It then states that three criteria have generally been used by the courts in determining whether parties to a transaction are not dealing at arm’s length, namely:

- (a) whether there was a common mind which directs the bargaining for both parties to a transaction;
- (b) whether the parties to the transaction were acting in concert without separate interests; and
- (c) whether there was “*de facto*” control.

CRA states that the courts have held that when one person (or a group of persons) is in fact the bargaining agent or the mind by which the bargaining agent is directed on behalf of both parties, the parties cannot be dealing at arm’s length. It states as well that this principle has been expanded to include the concept of “acting in concert” with respect to an element of common interest. As a result, according to CRA even when there are two distinct parties or minds to a transaction, if they act in a highly interdependent manner in respect of a transaction of mutual interest, it can be assumed that they are acting in concert and therefore are not dealing with each other at arm’s

---

<sup>60</sup> CSP-A07, October 25, 2002, which states that the opposite of arm’s length is not at arm’s length, which covers people acting in concert without separate interests, including individuals who are related to each other by blood, marriage, adoption, common-law relationships or close business ties.

length. Moreover, CRA states that when a common purpose exists, a transaction is not necessarily a non-arm's length one when different interests or independent parties are also present. CRA considers that there will be different interests when each party has an independent interest from the other parties to the transaction, notwithstanding the fact that each party may have the same purpose such as economic gain.

CRA also states that courts have held in certain cases that excessive or constant advantage, authority or influence can constitute *de facto* control. This is a legal concept which means effective control in fact without legal control. CRA states that the mere ability to exercise influence in and of itself may be sufficient, without the actual exercise of that influence.

Finally, CRA states, again, relying on jurisprudence, that failure to carry out a transaction at fair market value may be indicative of a non-arm's length transaction. However, it acknowledges that this is not conclusive and conversely a transaction carried out between unrelated persons at fair market value does not necessarily indicate they are dealing at arm's length. The key factor is whether they have separate economic interests which reflect ordinary commercial dealings between parties acting in their separate interests. Where one party is merely accommodating the other party in an attempt to obtain a certain tax result, the parties may be found not to be dealing at arm's length because they do not have separate economic interests which reflect ordinary commercial dealings between parties acting in their own separate interests.

It will be important to determine whether a person is or is not dealing at arm's length with a charity, if any transaction is open to an allegation that an undue benefit has been conferred. CRA has stated, for instance, that where a foundation is formed by a lawyer and members of his or her staff, the foundation will not qualify as a public foundation under the current rules (these rules are scheduled to be amended by the draft legislation introduced on July 18, 2005), because the directors will not be dealing with each other at arm's length. The correctness of this proposition has not been universally accepted. But for the "acting in concert" argument or the argument that the staff are under the influence of the lawyer, it would generally be felt that in all other matters, an employer and employee are dealing at arm's length. This illustrates the problem in

making assumptions in one fact situation and attempting to extrapolate them to a different fact situation. It also illustrates that it is not the theoretical relationship between the parties that governs, but the nature of the particular relationship involving the particular transaction. A person might be dealing at arm's length with a charity in most respects, but not be dealing at arm's length with it in respect of particular transactions<sup>61</sup>, which could expose the charity to a penalty for conferring an undue benefit on that person or a person not dealing at arm's length with that person.<sup>62</sup>

### **Fifty Percent Contribution Test**

An undue benefit will be conferred on a person by a registered charity where income is paid or payable for the personal benefit of a person who has contributed or otherwise paid into the charity more than 50% of its capital. The rule does not expressly state that the test is to be applied immediately before the relevant time. It is hoped that in administering this provision CRA will not allege that the fact that a person initially contributed more than 50% of the capital, where subsequently other arm's length persons contributed more than the initial contributor, will cause the person to be considered thereafter to be a person who "has contributed or otherwise paid into the charity more than 50% of its capital" for this purpose.<sup>63</sup>

In the draft legislation introduced on July 18, 2005, the definition of public foundation be changed, to deal with problems that have arisen in the past where a person or a group of non-arm's length persons had initially contributed more than 50% of the capital. Situations had arisen in which public foundations with a broadly-based board of

---

<sup>61</sup> Although it is not clear, it seems that the test is to be applied at the time the benefit is conferred. This suggests that a person who was previously not dealing at arm's length with a charity might, perhaps through a change of the board of directors or otherwise, be able to argue that at the time a payment or a gift is made, although he was previously not dealing at arm's length with the charity, he is in fact then dealing with it at arm's length. This would also be the case for the relationship between the beneficiary and the person to whom a payment or gift is made by a third party at the direction of the charity.

<sup>62</sup> For a recent analysis of the issues that must be considered in determining whether persons deal at arm's length, see *The Queen v. McLarty*, (unreported), court file A-85-05 (FCA), April 27, 2006, in which the Federal Court of Appeal also examined the application of the rules where an agent is involved on behalf of one of the parties.

<sup>63</sup> There are other issues about the meaning of "capital".

directors were in danger of losing their status as such and becomes private foundations because they received a single large gift from one contributor. The new rules will allow for this, as long as the person does not “control” the charity and there will be a “moving target” test, to determine whether a person has contributed more than 50% of the capital at a particular time. As a result, for that particular purpose, it is clear that the person’s status as a contributor is to be measured at a relevant time, and the test will not be met merely because he or she had at some point in the past contributed more than 50% of the capital. Although the definition of undue benefit does not expressly refer to this approach, logic suggests it should apply for this purpose as well.

Interestingly, unlike the concept in the definitions of public and private foundation, there is no “group” approach to contributions for purposes of undue benefits. In other words, the 50% contribution test must be met by the beneficiary and not by a group of non-arm’s length persons including the beneficiary. This suggests that, for instance, the shareholder of a corporation could cause it to contribute a significant amount to a charity and the shareholder would not be the contributor, although he would have caused the contribution to be made through a non-arm’s length relationship with the corporation. If the individual is not a member or director of the charity and deals at arm’s length with it, it seems that a payment to the individual, other than a gift, might not result in an undue benefit. One might have thought the Department of Finance would have tried to widen the net by including situations in which a group of non-arm’s length persons had contributed more than 50% of the capital to the charity.

### **Influence in an Arm’s Length Situation Without Substantial Contributions**

The move in the July 18, 2005 draft legislation to change the criteria for public and private foundations introduces the concept of control. This has introduced a nebulous concept that is more appropriate for corporations with share capital, involving an extended definition of control in fact.<sup>64</sup>

---

<sup>64</sup> Subsection 256(5.1), which refers to a situation in which a corporation is “controlled directly or indirectly, in any manner and states that this will occur where a person has direct or indirect influence that, if exercised, would result in control in fact of the corporation. The courts have considered the meaning of control for this purpose. See, for instance, *The Queen v. Lenester Sales Ltd.*, 2004 DTC

The courts have considered situations in which this type of indirect control, through influence, might arise through contractual arrangements, financing arrangements, etc. The definition of undue influence does not try to address situations of influence, and focuses rather on situations in which a beneficiary has individually been a significant contributor, receives a gift, receives a payment other than a reasonable amount for goods or services supplied, or does not deal at arm's length with the charity.

The JRT noted there were conflicting views on the advisability of imposing financial penalties on individuals who abuse a position of influence in a charity's affairs. The Act does not extend to broad concepts of influence, whether they would meet the test of control or otherwise. As a result, there will likely be many situations in which influential people are involved in transactions with charities, and may well play a critical role in decisions made by the charity that result in gifts or payments, without causing an undue benefit to be conferred for purposes of the penalty provisions. In the March 2004 budget, the circumstances in which an undue benefit would be recognized were referred to as "undue personal benefit provided by a charity to any person. For example, a transfer to a person who does not deal at arm's length with the charity or who is the beneficiary of a transfer because of a special relationship with a donor or a charity." The concept of "special relationship" does not appear to have found its way into the Act, except in the exclusion to the exclusion for gifts and payments that are in the course of an act in the ordinary course of charitable activities.

The Act contains many provisions dealing with the concept of "ordinary course of" or "in the course of". To the extent that the interpretation of these provisions is relevant in determining whether a charity is liable for a penalty because it has conferred an undue benefit, jurisprudence dealing with those provisions will likely be relevant. For instance,

---

6461 (FCA) in which it was held that franchise agreements, a unanimous shareholder agreement and various leases between one corporation and others did not give that corporation control over the other. See also *Silicon Graphics Limited v. The Queen*, 2002 DTC 7112 (FCA), in which it was held that, absent the application of subsection 256(5.1), a significant loan from a U.S. creditor was not sufficient to result in factual control. See also *Mimetix Pharmaceuticals Inc. v. The Queen*, 2003 DTC 5194 (FCA), in which the ability of a U.S. shareholder to exert influence was found to result in factual control under subsection 256(5.1). More recently, see *Timco Holdings Ltd. v. The Queen*, 2005 DTC 1628 (TCC), where *de facto* control was not found.

the rules that would include the amount of a loan in income of a shareholder contain an exception where a debt arose in the ordinary course of the business of the lender or a loan was made in the ordinary course of the lender's ordinary business of lending money. It has been held that "ordinary" implies that the business of lending money may be one of the ways in which the company as an ordinary part of its business operations earns its income.<sup>65</sup>

On the other hand, "in the course of" has a different but related meaning. For instance, it has been held that the words are not a reference to the time when an event occurred, but are used in the sense of "in connection with" or "incidental to" or "arising from" an event and refer to the process of carrying out or the things that must be undertaken to carry out the particular event or transaction.<sup>66</sup> The jurisprudence suggests that an expansive interpretation should be given to "in the course of a charitable act" as well as to "in the ordinary course of the charitable activities carried on by the charity".<sup>67</sup>

### **Possible Unintended Results**

If a registered charity transfers property to a person that is not a qualified donee, other than in the course of carrying on its charitable activities, it is liable to have its

---

<sup>65</sup> *Loman Warehousing Ltd. v. The Queen*, 2000 DTC 6610 (FCA), dealing with a separate provision (clause 20(1)(p)(ii)(A)), permitting a deduction for a bad debt. That provision requires the taxpayer to have an ordinary business that includes the lending of money and for the loan to be made or acquired in the ordinary course of the taxpayer's business of the lending of money. It has been held that the repeated use of the word "ordinary" for this purpose is important and the taxpayer must establish not only that its ordinary business included lending but that the particular loan was made in the ordinary course of that lending business. Isolated loans are often found not to be eligible. See *Yunger v. The Queen*, 2000 DTC 2153 (TCC).

<sup>66</sup> *MNR v. Yonge-Eglinton Building Ltd.*, 74 DTC 6180 (FCA), in which the issue was deductibility of expenses incurred in the course of borrowing money or issuing securities. In *BJ Services Company Canada v. The Queen*, 2004 DTC 2032 (TCC), that decision was followed and the court gave the expression its "plain and ordinary meaning", finding that the entire process of incurring expenses, regardless of who eventually acquired the shares in question, could be viewed as being in the course of the eventual sale of the shares.

<sup>67</sup> The proposed amendments to expand the circumstances in which registration can be revoked as a result of a disbursement by way of a gift will include exceptions for gifts made "in the course of" charitable activities carried on by the charity. See note 19, *infra*. The same issues of interpretation will arise in that context.

registration revoked under proposed amendments.<sup>68</sup> Presumably CRA will not resort to revocation where a gift has been made that gives rise to a penalty for an undue benefit. However, it seems that CRA will likely want to have the more draconian remedy available, if the assessment of a penalty for conferring an undue benefit is thought not to be sufficient.<sup>69</sup>

The new “split-receipting” regime deals with the quantification of a gift. The concept is based on the assumption that a transfer of property to a registered charity in circumstances in which the donor receives some advantage should reduce the eligible amount of the gift. The extensive proposed new rules in the July 18, 2005 draft legislation have been the subject of much discussion and extensive submissions made to the Department of Finance by the Charities and Not-for-Profit Law Section of the CBA and others. It is not clear that where a donor receives an advantage in exchange for a transfer of property, with the result that the eligible amount of the gift is reduced, there might not also be an undue benefit conferred on the donor by the registered charity, thus exposing it to a penalty. It is hoped CRA will not consider an undue benefit has been conferred on a donor who receives an advantage in exchange for a transfer of property, if the charity issues an official receipt for the correct eligible amount. Nevertheless, this is not entirely clear and involves reliance on an administrative policy of CRA.

Presumably, in construing whether such a benefit would be regarded as “undue” in the circumstances, based on the jurisprudence, a court would find that the economic benefit

---

<sup>68</sup> Proposed paragraph 149.1(2)(c) in the case of charitable organizations and proposed paragraph 149.1(3)(b.1) and proposed paragraph 149.1(4)(b.1) in the case of public foundations and private foundations, respectively.

<sup>69</sup> The fact that penalties can be avoided where they exceed \$1,000 in the aggregate, through a transfer of property to an eligible donee, suggests that conferring an undue benefit may be adequately dealt with through intermediate sanctions and only extreme cases should require consideration of the more severe sanction of revocation.

provided to the donor by the charity in a split-receipting situation would not warrant the imposition of a penalty.<sup>70</sup>

Other questions arise as to the proper characterization of a benefit conferred by a charity on a donor where there is arguably a contractual relationship (e.g. a transfer of property by the donor in exchange for consideration such as a meal) on the understanding that the eligible amount will be the difference between the value of the property transferred and the advantage obtained. It has been suggested that the advantage conferred on the donor by the charity may be a gift in these circumstances.<sup>71</sup>

In *Richert*, the plaintiff sought a declaration that \$1,000 he paid to a charity was not a gift but was held on a resulting trust and should be returned to him, since he did not receive the consideration for which he had bargained, namely a coffee table book. He received an official receipt for \$855, indicating that the value of the coffee table book had been deducted from the \$1,000. Based on affidavit evidence of the plaintiff, the court found that he had intended to make a gift of the difference and there was not a contract that required the charity to return the money to him. The court found that there was in essence a perfected gift for \$1,000 from the plaintiff to the charity and a “gift back” from the charity in appreciation. It stated further that while the transactions were related, on neither part were they a bargain or exchange of one thing of value for another. The court also stated that the fact that the Act measures gifts against all but the most trivial forms of recognition in determining the eligible amount of a gift may be reason for a taxpayer to inquire as to the value of such tokens in the future, but it does not change the fact that there is a complete gift effective on transfer of the money and

---

<sup>70</sup> For instance, if a director of a charity purchased a ticket for a fundraising event, for which it was clearly expected that only a portion of the payment would be treated as the eligible amount, there should be no suggestion that the amount for which an official receipt is not issued is an undue benefit conferred on the director. This is consistent with the proposition that “undue benefit” will not necessarily include every situation in which any amount is paid to a director that is not reasonable consideration or remuneration for property acquired or services rendered to the charity or otherwise excluded from the definition of undue benefit. In addition, there is an exclusion for an amount that would otherwise be an undue benefit, to the extent that a benefit is conferred in the course of a charitable act in the ordinary course of the charitable activities of the charity, unless it can reasonably be considered that the eligibility of the beneficiary relates solely to the relationship of the beneficiary to the charity.

<sup>71</sup> *Richert v. Stewards’ Charitable Foundation*, 2005 DTC 5647 (SCBC).

the gift cannot be undone merely because the taxpayer is not satisfied with the recognition that reduces the eligible amount.

I understand further litigation may be underway in the provincial courts, dealing with the nature of the relationship between a “donor” and a charity in split-receipting situations.

If a registered charity makes a gift to a person other than a qualified donee, it is liable to have its registration revoked.<sup>72</sup> This will also be grounds for the assessment of a penalty for conferring an undue benefit. However, there is an exception from the suspension sanction where the infraction is a gift, even if it is a gift to a person other than a qualified donee. This means that a gift to a foreign charity that is not a qualified donee will be grounds for revocation and grounds for a penalty, but will not in and of itself be grounds for a suspension of receipting privileges.

In calculating the revocation tax under Part V, the amount on which the tax is based will include appropriations with respect to property transferred to other persons within a stipulated time frame.<sup>73</sup>

### **Taxation of Benefits**

CRA has apparently chosen to follow an administrative policy that is consistent with the JRT approach. In other words, it appears that CRA will not assess individuals personally where they receive a benefit from a registered charity, where the intermediate sanctions are now available against the registered charity. Nevertheless, it appears that a member of a registered charity that is a corporation without share capital could be equated to a shareholder under CRA’s general administrative approach, and a

---

<sup>72</sup> See for instance, proposed paragraph 149.1(2)(c), which will apply to charitable organizations.

<sup>73</sup> Subsection 188(1.1). For this purpose, appropriations are generally the fair market value of property received by another person less the consideration paid for that property. CRA has stated that it does not regard a transfer to an eligible donee as an appropriation for this purpose. It is not clear whether an appropriation to a person other than an eligible donee, for less than “reasonable” consideration, would result in both revocation tax under subsection 188(1.1) and a penalty under subsection 188.1(4) for conferring an undue benefit.

benefit conferred on the member in that capacity could be subject to tax under subsection 15(1).<sup>74</sup>

Similarly, a benefit conferred on an individual in his or her capacity as an employee, officer or director could also be subject to tax, as could the benefit from an interest-free loan. Under paragraph 6(1)(a), the value of a benefit received or enjoyed by an employee (which will include an officer and director) must be included. In addition, the employer is required to deduct and remit tax and file an appropriate reporting slip. Under subsection 80(4), there is a taxable benefit in many situations where an interest-free loan is received. It appears that, in many of the situations at which the penalty for the conferral of an undue benefit is aimed, an individual might be subject to personal tax on the same amount. For instance, if a registered charity made a payment that conferred a benefit on a director, in addition to the penalty imposed on the charity, there could be exposure for personal tax.<sup>75</sup>

Under the Act, income must generally be from a source. If a person receives a benefit from a charity that is not income from employment, income from property or income from carrying on a business, it will likely not be taxable, although there are special rules for payments such as scholarships, etc.<sup>76</sup>

---

<sup>74</sup> In former interpretation bulletin IT-409, dealing with winding up of a non-profit organization, CRA noted that the definition of “shareholder” includes a member of a corporation without share capital, if the person is entitled to receive payment of a “dividend”, in accordance with the definition in subsection 248(1). If the constituting documents of a registered charity prohibit any payment on winding up to a member, it seems that a member might not be regarded as a shareholder and thus might not be liable for assessment on a taxable benefit conferred on the person, even if that benefit were conferred on the person in his or her capacity as a member. Thus, it seems that the very benefit conferred on a member that would give rise to an undue benefit and a penalty against the charity would perhaps not be a taxable benefit to the member.

<sup>75</sup> In Ontario, there are rules prohibiting the payment of remuneration to a director, even for services rendered in some other capacity.

<sup>76</sup> Under section 3, income must be determined from each source including, without limitation, income from each office, employment, business and property. In addition, certain amounts are included under subdivision d of division B in Part I, such as scholarships, research grants, etc. As a result, a student receiving a scholarship is required to include it in income and a person who has caused the scholarship to be paid, resulting in an undue benefit to the charity might, also be considered to have received a benefit in some cases, on the theory in subsection 56(2). From the perspective of a charity subject to a penalty under subsection 188.1(4), these issues are likely irrelevant, since the issue is whether it has conferred a benefit inappropriately.

In commercial arrangements, it is not unusual for a person to transfer property to a corporation in exchange for treasury shares, filing a joint election to defer tax on any unrealized gain. The rules are complex and intended to ensure that the shares acquired in exchange have the appropriate value. One particular rule<sup>77</sup> deals with the circumstances in which a person transferring property to the corporation might confer a benefit on other shareholders.<sup>78</sup> There are similar provisions in other corporate reorganization rules in the Act, dealing with exchanges of shares, amalgamations, etc. This will occur where the value of the property immediately before it was transferred to the corporation exceeds, in effect, the value of the shares received in exchange, “and it is reasonable to regard any part of the excess as a benefit that the taxpayer desired to have conferred on a person related to the taxpayer”. This provision clearly requires an element of intent, in the sense that the mere conferral of a benefit is not sufficient and it must be reasonable to regard the excess value as a benefit that the taxpayer “desired” to have conferred on another person.<sup>79</sup> At one time, the concept was narrower, and the requirement was that the taxpayer confer a gift rather than a benefit. This illustrates yet another situation in which the concept of a conferred benefit raises tax consequences. Presumably the legislators and the courts will take into account the various circumstances in which conferred benefits are addressed in the Act, in interpreting the scope of the penalty for conferring an undue benefit under subsection 188.1(4).

I understand CRA feels it can assess a fundraiser who receives remuneration from a registered charity in connection with fundraising activities of the charity. This apparently would be treated as business income or income from some other source for purposes of section 3 of the Act.

---

<sup>77</sup> Section 85.

<sup>78</sup> Paragraph 85(1)(e.2).

<sup>79</sup> In the case of most other benefits, the mere fact that the benefit has been conferred is sufficient. This is certainly the case where a benefit is conferred on a shareholder and subsection 15(1) applies.

### **Quantification of Benefits**

The penalty will depend on the amount of the undue benefit conferred. This should be fairly easy to determine where there is a disbursement by way of a gift, although the fair market value may be relevant if the gift is made in the form of property rather than cash. Otherwise, the benefit will be determined as the “amount” of income, rights, property or resources of the charity involved, or the amount of the benefit conferred on a beneficiary by a third party at the direction of the charity or with the consent of the charity. The jurisprudence dealing with the quantification of benefits received by employees or conferred by corporations on shareholders, and under other provisions in the Act dealing with quantification of income will all be relevant. The Act defines “amount” to mean money, rights or things expressed in terms of the amount of money or the value in terms of money of the right or thing, with certain exceptions.<sup>80</sup> In some cases, the quantification of the amount may not be a simple exercise.

### **Specific Exclusions**

The enumerated exclusions in the definition of undue benefit will be relevant in many situations. There are basically three situations in which an amount that would otherwise be an undue benefit will be permissible. There will be no undue benefit where a gift is made to a qualified donee. There will be no undue benefit where an amount that is “reasonable” consideration or remuneration for property acquired or services rendered to the charity is involved. This will raise factual questions about reasonableness but clearly is intended to permit normal commercial transactions to occur. As a result, in addition to the uncertainty about whether a benefit would be undue in any event, the collateral question will be whether it is not undue because the amount in question is “reasonable”. The other exclusion is for a gift made or a benefit conferred “in the course of a charitable act in the ordinary course of the charitable activities carried on by the charity, unless it can reasonably be considered that the eligibility of the beneficiary for the benefit relates solely to the relationship of the beneficiary to the charity”. This

---

<sup>80</sup> Subsection 248(1).

seems to be the only indication of the reference in the JRT to influence and in the explanatory notes to the September 16, 2004 draft legislation and the technical notes accompanying Bill C-33 to a “special relationship”.

It will usually be a simple matter to determine whether a gift has been made to a qualified donee.<sup>81</sup> It should usually be relatively straightforward to determine whether a gift has been made or a benefit has been conferred in the course of a charitable act in the ordinary course of a charitable activity, although questions may arise where the activity itself might be regarded as an administrative function, such as fundraising. If a disbursement would not be regarded as “on side” for purposes of meeting the disbursement quota, it will not be “on side” for this purpose. As a result, there will be some uncertainty in many situations as to whether a particular payment is made in the course of carrying on charitable activities.<sup>82</sup> If this test is met, the further requirement is that the gift not be made and the benefit not be conferred solely because of a special relationship. In most cases this will be self-evident. In hard cases, there may be doubt about the linkage between a gift or payment and the relationship of the recipient to the charity, even if there is no beneficiary as contemplated in the definition of undue benefit.

Some observers have suggested that, for instance, a member of a religious group who is able to use the premises of a church or synagogue for less than “market” rates as compared to the rate that might be charged to a member of the “public” would not be able to rely on this exclusion, because the benefit might be conferred solely because of

---

<sup>81</sup> As noted above, there may be situations in which some consideration is received by the transferor charity. The problem addressed in the split-receipting rules, for purposes of determining the eligible amount of a gift, will not cause a transfer to be a gift at common law and the new rules may not treat it as a gift for other purposes in the Act. There are other questions under civil law in Quebec. This raises a number of potential issues, not the least of which is that a disbursement that is not a gift may not be grounds for revocation of registration.

<sup>82</sup> In CRA document no. 2002-0180335, note 44 *supra*, CRA dealt with a situation in which a corporation was formed for the purpose of facilitating payments by registered charities to settle tort claims. CRA was not prepared to characterize payments of tort claims as amounts expended on charitable activities. It acknowledged that payment of civil claims can be an expenditure by a charity in the normal course of operating and noted that the Act draws a distinction between expenditures on charitable activities and expenditures on administrative or operational expenses. In the absence of legal precedents specifically on point, CRA was not prepared to conclude definitively whether payments made to settle tort claims would be considered a charitable activity. This illustrates the uncertainty that often arises in grey areas.

the special relationship that exists merely through membership in that group, even if the person is not a member in the technical sense. A similar issue arises if a museum or symphony offers discounts in a gift shop to its “members”. If membership is a requirement for the discount, and the amount paid is arguably not “reasonable” because non-members pay more, and if the benefit is conferred solely because of membership, it seems the exception is not available. I understand CRA is not likely to take this position unless there are extreme circumstances. It appears that a benefit available to all members in this situation will not depend on a special “relationship”. This assumes, of course, that the benefit is conferred in the course of a charitable act in the ordinary course of the charitable activities of the charity.

### **Examples**

With the foregoing as a backdrop, it is illuminating to try to anticipate how these rules will be applied in practice. Many situations will be self-evident, but others will be fraught with difficulty.

For instance, consider the situation of the headmaster of a private school who is an employee and also a member of the board of directors. If that person makes a donation to the school, it seems to be well accepted that the full amount of the payment would be regarded as the eligible amount, unless there were some clear advantage received in exchange. However, suppose the school is encountering financial difficulty, and the salary of the assistant headmaster might be in jeopardy. It would not stretch the imagination to consider a situation in which the head master might be inclined to make a sizeable contribution, claiming the associated tax credit, in order to ensure that the salary to the other employee continued. Of course, whether the donation would have been made in any event would be debatable and this raises the very fundamental question about intent and illustrates the difficulty that has been addressed to some extent with the new rules dealing with split-receipting, advantages and other issues. As long as the salary paid to the assistant headmaster is reasonable, there should be no issue about an undue benefit. This seems to be a reasonable approach to the situation, and the fact that the headmaster is the director should be irrelevant, even if the

assistant head master is related to the headmaster, as long as the amount is reasonable.

Contrast this situation with a smaller charity, in which the director causes a payment to be made to his child, in excess of a reasonable amount. Since the parent and the child would not be dealing at arm's length with each other, there would clearly be an undue benefit.

If the parent as director caused a scholarship to be paid to his child, there would be an undue benefit if it could be established that the scholarship was paid solely as a result of a relationship. If the directors of the charity or appropriate committee or other group overseeing the awarding of scholarships is involved, and it is clear that the student has qualified according to objective criteria, there should be no undue benefit.

Suppose the parent of a university student makes a payment to the university, on the "understanding" that the student will be eligible for a trip as a member of a university club to a distant location, the travel costs of which will be subsidized or paid by the university. Even if there is not the degree of connection required to reduce the eligible amount of the gift by the "advantage" that arguably might be received by the parent as a result of the fact that the student would have a better chance of being able to travel with the other members of the club, a collateral question arises as to whether the university itself may be liable for a penalty for conferring an undue benefit on the donor. If the donor is not a member or director, has not contributed more than 50% of the capital and deals at arm's length with the university, there should be no undue benefit. Conversely, if the parent is a director, with many arm's length persons, it appears that a payment made for the personal benefit of the son, who does not deal at arm's length with the director, might expose the university to a penalty, if the payment is made solely because of a relationship "of the beneficiary to the charity".<sup>83</sup> This will often be difficult to establish. CRA might argue that the director (the beneficiary) has received the benefit

---

<sup>83</sup> There is no definition of what is meant by "relationship" for this purpose. It is the beneficiary, rather than the recipient of the gift or benefit conferred, that must have the relationship.

as a result of the fact that resources of the university are “made available” for the personal benefit of the student.

It will be important for charities to have transparent criteria for awarding scholarships, bursaries or prizes or otherwise giving support to those at whom their charitable activities are aimed. For instance, the child of a director should not be precluded from receiving a scholarship, as long as the criteria applicable to all candidates are met by that student and the relationship between the director and the charity is not the sole reason for which the scholarship is awarded to the student. In extreme cases, particularly with smaller charities and a small number of candidates, this could perhaps lead to abuses.<sup>84</sup>

There may be “benefits” the quantification of which will be difficult to determine, in situations where there is an advantage that is not necessarily a result of a payment. An undue benefit can arise where a charity makes available any of its resources for the personal benefit of the beneficiary. This would presumably include situations such as interest-free loans, the use of a work of art for which no rent is paid or the use of office space or other premises, etc. for less than a commercial rate. An entrepreneur carrying on a business, such as the publication of a magazine or the operation of a school, may consider “converting” the operation into a charitable endeavour. While this is commendable in most situations, often the entrepreneur is also interested in establishing an arrangement either personally or through a corporation, under which premises will be leased to the new charity, services will be provided or goods will be acquired or sold. There have always been issues of conflict of interest and breach of

---

<sup>84</sup> I am reminded of the story of a castle on the Rhine in Germany, which was bought by a non-resident. Apparently, there are restrictions on the personal ownership of these properties by non-residents, but commercial use for hotels is permitted. I understand the castle is nominally regarded as a hotel, but the prices are so high that no guest has ever stayed there. To some, this might appear to be an “end run” around the rule, with the result that the “hotel” is in fact nothing more than a personal residence. If a charity is able to establish criteria that are specifically aimed at a narrow group of candidates and those candidates can be alleged to have received support solely as a result, it may be appropriate for a penalty to be imposed for conferring an undue benefit. If, for instance, a director’s child is a poor student, and the bursary is awarded for the lowest mark in the class (on the theory it will help the student by eliminating the need to work part-time), there may be an inference that the relationship was a basis for establishing the award. This raises other issues about private benevolence.

trust associated with these situations. There will now be further concerns for the charity, if it confers a benefit in these circumstances. It will therefore be very important for the charity to ensure that all dealings occur at a reasonable amount, to the extent that its resources are made available to a beneficiary, or payments or gifts are made to the beneficiary, if these transactions occur as part of the charitable activity. If the charity is not carrying on charitable activities, the risk of revocation will remain, quite aside from risks of penalties for conferring undue benefits.

Consider a situation in which a foundation holds shares of a public company. A director of the foundation may personally be involved in transactions in which he wishes to make a takeover bid for the company. It is not clear if the participation of the charity in tendering its shares in a takeover bid (or not tendering to a competing offer) might be regarded as making its resources available for the personal benefit of the director in these circumstances. Suppose a charity buys a huge amount of stationery from a director's corporation at a reasonable price, recognizing that it will very likely become obsolete. The amount paid would be reasonable based on the market value, but the decision to buy so much would probably not be reasonable. The amount paid may nevertheless be reasonable consideration from the seller's perspective, and there may be no undue benefit. At a minimum, the directors of the charity would want to ensure that they receive independent advice about the advisability of taking steps in situations that might arguably involve a personal advantage for a director or other beneficiary. Even if this "advantage" were regarded as some type of benefit associated with the resources of the charity, it is difficult to see how one could realistically quantify it. This illustrates that the penalty will be applicable only where the amount can be determined.<sup>85</sup>

In many situations, it may be advisable for individuals to distance themselves from charities before undertaking transactions that may be called into question. Since the

---

<sup>85</sup> As a practical matter, there would be nothing to prevent CRA from assessing a penalty by assuming the amount of the benefit, and shifting the onus to the charity to rebut the assumption through a notice of objection. In tax law, an assessment is presumed to be correct until the taxpayer establishes that it is not correct.

rules do not go so far as to look at the concept of control, as they do in the case of designations for public foundations and private foundations, there may be some latitude to avoid having the charity confer an undue benefit with careful planning.

Presumably in most if not all cases, there will be a fairly clear link between a payment in the ordinary course of charitable activities of a charity and one that can be identified as being made solely because of a relationship between the charity and the beneficiary. Even if the relationship involves the kind of influence that would result in control in fact under the rules that are applicable for determining whether a foundation is a public or private foundation, the pre-requisite for an undue benefit would not arise if there is no beneficiary because there is no director or member, no person who has contributed more than 50% of the capital and no person who deals not at arm's length with the charity or with a director, member or a contributor of more than 50% of the capital.

### **CRA's Administrative Position**

In an address delivered to the Fourth National Symposium on Charity Law on May 11, 2006, Elizabeth Tromp outlined the general approach that CRA intends to take, at least in the short term, in applying interim sanctions, including interim sanctions for the conferral of undue benefits.

As a general rule, CRA plans to use educational methods to ensure compliance, and then move to a spectrum of enforcement initiatives, including compliance agreements with charities that are "offside", imposing intermediate sanctions and ultimately, if necessary, revocation of registration. It is clear that CRA does not intend to forego the use of revocation in those cases where it considers the infractions are serious, particularly for charities that do not seem to be prepared to become "educated" or to enter into compliance agreements or improve their conduct.<sup>86</sup>

I understand CRA will consider serious cases to include those where the activities or purposes are no longer charitable in and of themselves or where the non-compliance

---

<sup>86</sup> Subsection 189(7) permits the Minister to assess interim sanctions without limiting the ability to revoke registration.

reaches certain thresholds (which might be measured in absolute terms such as a dollar value of expenditures or the amount of an undue benefit, or in relative terms, such as a percentage based on overall assets or resources), where the non-compliance involves criminal conduct, where the non-compliance involves breaches of what are considered to be “core” requirements in the Act or where, having entered into a compliance agreement, the charity does not respect its terms.

In addition, I understand CRA will consider using revocation rather than an intermediate sanction where there are aggravating circumstances, which would include a previous record of serious non-compliance, coupled with evidence of intentional non-compliance, a substantial adverse impact on third parties, such as beneficiaries or donors, or situations in which the organization is unable or unwilling to comply.

CRA will continue to revoke the registration of charities that do not file the annual form T310 on a timely basis, although this will not prevent the charity from paying a \$500 re-registration fee and applying for re-registration, as long as it still qualifies for registered status.

Consequently, it appears that CRA is prepared to allow some leeway to the charitable sector through an educational process, and provide reasonable opportunities for charities to remedy non-compliance before assessing intermediate sanctions.

CRA has indicated that in most cases it expects to enter into a compliance agreement with a charity before imposing an intermediate sanction for the conferral of an undue benefit, unless the infraction is serious or is part of a series of repeated offences or there is evidence of intentional non-compliance.

### **Miscellaneous**

Where a benefit is provided by a charity to a member, there may also be GST implications. For instance, generally supplies made by a registered charity are exempt from GST, including supplies of memberships. However, where members also receive certain benefits in exchange for membership, the fee paid for membership may be

subject to GST. One such benefit is a discount that is not insignificant in relation to the membership fee.<sup>87</sup>

CRA has administratively taken the position that a discount is insignificant in relation to membership if the total discounts are less than 30% of the fee paid for the membership. For this purpose, the discount is the difference between the amount payable by the member for the goods or services received from the charity at the fair market value of the goods or services received.

As a practical matter, this appears to establish a form of *de minimis* threshold for GST purposes. There seems to be no correlation between this approach for GST purposes and the measurement of an undue benefit for purposes of the penalty tax in Part V of the ITA. However, the objectives appears to be similar, in the sense that the GST rules recognize that benefits might be made available to all members as a class, without causing those benefits necessarily to disqualify the membership fee from tax-exempt status. This would perhaps be a benefit linked solely to the relationship between the member and the charity. On the other hand, if the benefit takes the form of a discount, even if it is available to all members, it must be “insignificant”. In the context of undue benefits conferred by a charity for purposes of intermediate sanctions under the Act, it seems that as a practical matter, CRA is likely to disregard benefits that are conferred only on all members, even if they are conferred solely because of the relationship between the member and the charity, if the benefits are insignificant and the relationship is not “special”. However, this is not clear.

---

<sup>87 87</sup> Under section 17 of Part VI of Schedule V of Part IX of the *Excise Tax Act*, there is an exemption from GST for a supply of a membership as long as the members do not receive, by reason of membership, any benefits other than those that are specified. The specified permissible benefits include the following: (a) an indirect benefit intended to accrue to all members collectively; (b) the right to receive services supplied by the charity that are in the nature of investigating or settling complaints or disputes involving members; (c) the right to vote at meetings; (d) the right to receive or acquire property or services for a separate consideration that is not part of the consideration for the membership and that is equal to the fair market value of the property or services at the time the supply is made; (e) the right to receive a discount on the value of consideration for a supply to be made by the charity if the total value of the discounts is “insignificant” in relation to the consideration for the membership; and (f) the right to receive periodic newsletters, reports or publications that meet certain criteria.

A comparison to the situation in the United States is also interesting. Under the U.S. rules, there are excise taxes on excess benefit transactions and the Internal Revenue Service (“IRS”) has been given an additional way to enforce the prohibition on private benefits.<sup>88</sup> Apparently these excise tax taxes, which are also viewed as a form of intermediate sanction, were thought to be a more effective way to enforce the “no-inurement” requirement under U.S. law than revocation of exempt status in most instances, where the transgression was relatively minor, compared to the charitable activities. The U.S. Treasury has recently issued proposed regulations relating to situations in which the IRS will revoke exempt status for violation of the no-inurement rules, rather than merely impose intermediate sanctions in the form of taxes on excess benefits. In the U.S., the private benefit rule is not the same as the prohibition of inurement, which is aimed at the removal of assets or income of an organization for the benefit of those who might be considered to be “insiders”. On the other hand, the excess benefit transactions rules are based on the prohibition of private inurement and not the private benefit rules. According to Wexler and Geske, the two parts of the proposed regulations require separate analysis. Wexler and Geske conclude that the substantive provisions in the proposed regulations should not offer any surprises to those who have been following the development of the intermediate sanction rules in the U.S. However, they point out that the detailed examples may be helpful for practitioners who uncover potential problems with compliance with the intermediate sanction rules, by pointing to “self-correcting” and “damage-mitigating” actions that can be taken by an organization. They also note that even before the guidelines are in place, the potential effects are being felt in two important areas, namely the exemption application process and on practitioners. The IRS seems to be building into the exemption application process requirements that the applicant put in place procedures designed to prevent certain offensive practices. In particular, the IRS has apparently been requiring an organization to include in its governing documents a clear conflict of interest policy and procedures to verify the reasonableness of compensation. In

---

<sup>88</sup> For a recent discussion of some of the implications in the U.S., see Wexler and Geske, “The Private Benefit Rule and Interaction of Excess Benefit Transaction Taxes with Revocation”, *Journal of Taxation*, May, 2006, p.304.

addition, the IRS is apparently increasing its examination of larger charities, particularly those with high compensation levels for officers or employees. Penalties tend to be harsher where the IRS discovers misconduct, rather than where it is disclosed voluntarily. This apparently has put a higher onus on practitioners.

The detailed provisions of U.S. law and many of the examples in the article raise interesting points, which are beyond the scope of the issues discussed in this paper.

### **Conclusion**

While the concept of penalties for conferring undue benefits is in and of itself not objectionable, as a practical matter there will be concerns about the scope of the word “undue”, the reliance on the concept of arm’s length and the presumption that a member or director or significant contributor who receives a payment is somehow necessarily required to rebut a presumption that the payment or other benefit has been made by the charity in the course of its charitable activity or as reasonable consideration for property acquired by or services rendered to the charity.

It seems clear that not only directors but members will be required to be very sensitive to the potential implications for the charity if they are involved in any transactions with the charity.

This will presumably be addressed through a self-assessing system using the annual T3010 return filed by the charity and perhaps through other audit techniques. I understand CRA is currently reviewing the content, purpose and format of the T3010 and related matters, including the provisions in the Act dealing with disclosure. The current version of the form asks whether the charity paid compensation to any of its directors or trustees and whether, except for compensation, it directly or indirectly transferred any part of its income or assets to individuals or organizations not dealing at arm’s length with it. The re-designed form may include questions that are more specifically aimed at determining whether an undue benefit has been conferred. Regardless of the disclosure required in form T3010 or any other forms that are required under the Act or regulations, directors, officers and managers of registered

charities should institute a program to identify potential beneficiaries and transactions that might give rise to an undue benefit and thus a penalty against the charity.

In many cases involving private foundations, virtually every transaction with directors or major contributors will be fraught with potential problems. However, in other charities where there are a broadly-based board of directors and a broadly-based source of capital, the situations may be less obvious. Ensuring that all gifts and other payments made by the charity in the ordinary course of carrying on charitable activities, and that all payments are reasonable in the circumstances and the resources are not misdirected, should provide a considerable amount of insurance against inadvertently running afoul of these rules.