Policy Forum: A Comment on Valuing In-Kind Charitable Gifts of Property and Leveraged Charitable Donations

Editor’s note. Tax shelters—arrangements in which a significant portion of the investor’s return is in the form of tax benefits that not only offset any tax liability that may arise from the investment but also “shelter” other income, such as wages—always have been a minor industry in Canada. Over the past 30 years, the most notorious tax shelter investments have included aircraft, movies, scientific research, resource exploration and development, and computer software. As the tax benefits associated with these investments have been gradually reduced, in recent years the most prolific and abusive tax shelter arrangements have involved charitable donations of gifts-in-kind and leveraged charitable donations. These arrangements fall squarely within the definition of a tax shelter offered by Michael Graetz, a professor of tax law at Yale Law School: “a deal done by very smart people that, absent tax considerations, would be very stupid.”

If the economic cost to taxpayers of an item of property is, say, $20, and they can donate the property to a charity and claim that its fair market value is $100, their tax savings, as much as $46 in Ontario, will far exceed both their cost of the property and the tax (if any) that they have to pay on the accrued gain. These excess tax benefits can be used to shelter other income from tax. Why would the fair market value of the donated property exceed its cost by such a large percentage? In the normal case, a property’s value will exceed its economic cost because over a period of time the supply of and demand for the property will have changed. However, in tax-sheltering arrangements, the property would normally be donated to a charity almost immediately after its purchase. The promoters of these schemes argue that the difference in the economic cost of the property to the taxpayer and its fair market value might be attributable to, for example, the fact that the property had been bought by the taxpayer for a huge discount because it was bought as part of a bulk purchase. When these tax shelter arrangements first became popular, the property that formed the subject matter of these schemes was normally hard-to-value assets such as artwork, but more recently the property has included items as diverse as prepackaged food and pharmaceuticals.

Over the years, the government has introduced specific amendments to the Income Tax Act to deal with the most abusive charitable-giving schemes as they arose. However, in the past year it has proposed to take a more comprehensive approach

to these tax shelters. In the February 2003 budget, the government announced that
certain gifting arrangements involving the tax credit for charitable donations would
have to be registered as tax shelters. It also announced that all charitable gifts would
be reduced by the amount of any associated limited-recourse debt. Then, on Decem-
ber 5, 2003, the government announced that further amendments would be introduced
to limit the value of the donor’s charitable donation to the donor’s economic cost if
the property was acquired through a gifting arrangement or if the property was
either donated within three years of being acquired by the donor or acquired with
the expectation that it would be the subject of a charitable gift.

Daniel Sandler and Tim Edgar thoroughly review the development of these tax
shelters, the various efforts by the government over the years to curtail them, the
related jurisprudence, and the recently proposed amendments. Although they are
in general agreement with the proposed amendments, they take issue with certain
details. For example, they question the need for the arbitrary three-year rule for
property that is not acquired as part of a marketed scheme. They also argue that
since there appears to be no reason why marketed schemes are necessary to achieve
the objectives of the tax expenditure program for charitable giving, perhaps there
should be no recognition at all for gifts that are part of a marketed gifting scheme.