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Investment Rules and Restrictions Applicable to Ontario Private Foundations

By Greg Farano

We were approached recently by an Ontario private foundation (a non share-capital corporation) which was considering making available to a private share capital corporation by way of direct or indirect loan or subscription for shares a multi-million dollar securities portfolio owned by the private foundation. The private share capital corporation required the securities portfolio on a temporary basis in order to secure a bridge loan required by the corporation in connection with its business activities.

In considering whether and on what terms to advance, directly or indirectly, to a third party by way of debt or equity any portion of an Ontario private foundation's property, the private foundation must consider the application or potential application of, (i) the "prudent investor", diversification and other investment rules in the *Trustee Act* (Ontario), (ii) the business ownership restrictions in the *Charitable Gifts Act* (Ontario), (iii) the "undue benefit" rules in the *Income Tax Act* (Canada) ("ITA"), (iv) the required rate of return rules prescribed in the ITA for a "non-qualified investment", and (v) the new monitoring, reporting and excess corporate holdings rules in the ITA.

This article will discuss these rules and restrictions as they would apply to an Ontario private foundation, beginning with a brief discussion of the statutory definition of a private foundation.

Background – Charities and Foundations

Briefly, section 149.1 of the ITA provides for two main categories of registered charities, namely charitable organizations and charitable foundations. Charitable foundations are further subdivided into two categories, private foundations and public foundations. In general, a charitable organization does direct charitable work whereas a charitable foundation raises money and gives it to charitable organizations. Having said this, a charitable organization can meet the requirement under the ITA to devote all of its resources to charitable activities carried on by it by transferring up to 50 percent of its annual income to other "qualified donees". The term "qualified donee" includes a registered charity, a registered Canadian amateur athletic association, a municipality in Canada, a university outside Canada that is prescribed to be a university the student body of which ordinarily includes students from Canada, a charitable organization outside Canada to which the Canadian government has made a gift in the year or in the 12-month period preceding the year, and the Canadian or a provincial government. And although a foundation, whether public or private, is allowed to transfer 100 percent of its annual income to other qualified donees, it may have the legal capacity to carry on charitable activities directly if its constating documents provide for this.

A public foundation is a charitable foundation which meets the arm's length governance and funding thresholds in the ITA, that is (i) more than 50 percent of the directors/trustees/officers of the foundation deal at arm's length, and (ii) not more than 50 percent of the foundation's funding comes from a single person or from a group of persons who do not deal with each other at arm's length. Bill C-10 (which has yet to be enacted) replaces the latter "contribution test" with a new "control test". Under the new "control test", a charity will not be disqualified from being treated as a public foundation based solely on the source of its funding. Instead, the "control test" allows a person, or group of related persons, to contribute more than 50% of the charity's capital provided they do not control the charity in any way. In addition, this person, or members of the related group, may not represent more than 50% of the directors, trustees, officers and similar officials of the charity. Failure to satisfy the "control test" will result in a charity being designated as a private foundation. The Canada Revenue Agency is now applying the "control test" in its review of applications for registration and re-designation.

A private foundation is a charitable foundation which does not meet these arm's length thresholds. Further, under the ITA, a private foundation is subject to a number of restrictions. For example, no part of the private foundation's income may be payable to, or is otherwise available for, the personal benefit of any "proprietor, member, shareholder, trustee or settlor" of the foundation. A private foundation, (i) cannot carry on any business activities (unlike public foundations and charitable organizations), (ii) cannot incur debts other than debts for current operating expenses, the purchase and sale of investments, or the administration of the charitable activities, (iii) cannot acquire control of another corporation, except by gift but within limits, and (iv) must comply with the disbursement quota requirements under the ITA by disbursing at least the required minimum amount of its assets.

Application of the *Charities Accounting Act* (Ontario) and the *Trustee Act* (Ontario)

Subsection 1(2) of the *Charities Accounting Act* (Ontario) provides that:

> Any corporation incorporated for a

> religious, educational, charitable or public purpose shall be deemed to be a trustee within the meaning of this Act, its instrument of incorporation shall be deemed to be an instrument in writing within the meaning of this Act, and any real or personal property acquired by it shall be deemed to be property within the meaning of this Act.

Accordingly, all Ontario private foundations which are corporations are deemed to be a trustee for the purposes of the *Charities Accounting Act* (Ontario) and are subject to the disclosure requirements of that Act, namely a requirement to furnish to the Public Guardian and Trustee upon its request, (i) particulars of the administration or management of the foundation, and (ii) accounts of dealings with the property coming into the hands or under the control of the foundation. If a foundation is, among other things, found to have made any improper or unauthorized investment of any money forming part of the proceeds of any property of the foundation, a judge of the Superior Court of Justice may on the application of the Public Guardian and Trustee among other things make an order requiring that the property be paid into court.

Paragraph 1.1(b) of the *Charities Accounting Act* (Ontario) provides that sections 27 to 31 of the *Trustee Act* (Ontario) apply to a corporate foundation that is deemed to be a trustee under subsection 1(2). Sections 27 to 31 of the *Trustee Act* (Ontario) among other things impose a "prudent investor" standard on a corporate foundation in connection with any investment of its property. In particular, and in deciding whether and on what terms to invest a foundation's property, a foundation's board must consider the following criteria, (i) general economic conditions, (ii) the possible effect of inflation or deflation, (iii) the expected tax consequences of investment decisions or strategies, (iv) the role that each investment or course of action plays within the foundation's overall portfolio, (v) the expected total return from income and the appreciation of capital, (vi) needs for liquidity, regularity of income and preservation or appreciation of capital, and (vii) an asset's special relationship or special value, if any, to the purposes of the foundation. Further, the foundation must diversify the investment of its property to an extent that is appropriate to, (i) the requirements of the foundation (which would include meeting its disbursement quota under the ITA), and (ii) general economic and investment market conditions. A foundation may obtain, and where appropriate rely on, advice in relation to the investment of its property.

Ownership Restrictions under the *Charitable Gifts Act* (Ontario)

Subsections 2(1) and (2) of the *Charitable Gifts Act* (Ontario) ("CGA") provide as follows:

> 2.(1) Despite any general or special Act, letters patent, by-law, will, codicil, trust deed, agreement or other instrument, wherever an interest in a business that is carried on for gain or profit is given to or vested in a person in any capacity for any religious, charitable, educational or public purpose, such person has power to dispose of and shall dispose of such portion thereof that represents more than a 10 per cent interest in such business.
>
> (2) Subsection (1) does not apply to an interest in a business given to or vested in any organization of any religious denomination.

Section 2 of the CGA prohibits an Ontario charitable organization or foundation (religious denominations are excepted) from owning more than 10 percent of a "business". Where the business is carried on by a corporation, this means 10 percent of the shares of that corporation. This ownership restriction does not exist in certain other provinces. Section 3 of the CGA requires that any interest in a business in excess of a 10 percent interest in such business must be divested within 7 years of the death

of the testator, if the interest was acquired by testamentary instrument, or within 7 years after the date of the relevant instrument, if acquired other than by testamentary instrument.

Section 8 of the CGA gives a judge of the Ontario Superior Court of Justice, upon application by the Attorney General or an interested person, the authority to, "make such orders as he or she considers proper to carry out the intent of this Act or to determine any matter arising under it". Section 9 sets out various penalties for a contravention of the CGA.

Several methods have been suggested for avoiding the 10 percent ownership limit in the CGA. Firstly, some or all of the directors and officers of the foundation might incorporate a non-share capital, non-profit corporation and become the members and directors of this corporation. The non-share capital corporation might in turn incorporate a for-profit, share capital corporation, and divert up to 75 percent of that corporation's profits back to the foundation. Secondly, the foundation might become a beneficiary of a business trust, with the subject business carried on by the business trust.

"Undue Benefit" Rules in the *Income Tax Act* (Canada)

Subsection 188.1(4) of the ITA prescribes a penalty for registered charities, including private foundations, which confer on a person an "undue benefit", as that term is defined in subsection 188.1(5).

The concept of "undue benefit" found in subsections 188.1(4) and 188.1(5) is new but it derives, in general terms, from prohibitions contained in the definitions of "charitable foundation" and "charitable organization" in subsection 149.1(1) that provide that "no part of the income of which [charity] is payable to, or is otherwise available for, the personal benefit of any proprietor, member, shareholder, trustee or settler thereof, [and that is not a charitable organization]". The last parenthetical expression is only found in the definition of "charitable foundation". The original penalty is 105 percent of the benefit in question, increasing to 110 percent in the case of a second penalty within a five year period.

An "undue benefit" is defined in subsection 188.1(5) and, in general terms, includes any income, rights, property or resources of the charity that is paid, payable, assigned or otherwise made available for the personal benefit ("Benefits") of any proprietor, member, shareholder, trustee or settlor of the charity who has contributed or otherwise paid into the charity more than 50 percent of its capital. It also includes Benefits conferred upon:

(a) a person who does not deal at arm's length with such a donor or with the charity itself, or

(b) a person by a third person at the direction or with the consent of the charity,

that would otherwise be an amount to which the charity would have a right. Excluded from the concept of "undue benefit" are reasonable payments for property or services, gifts made by a charity in the ordinary course of its charitable activities (except where the eligibility for the gift relates solely to the relationship of the Benefits recipient to the charity) and gifts to qualified donees.

Required Rate of Return Rules for Non-Qualified Investments under the *Income Tax Act* (Canada)

In addition to the disbursement quota rules in the ITA (which are not addressed in this article), section 189 of the ITA is designed to ensure that private foundations are not used to provide financial benefits to, among other persons, non-arm's length corporations. A "non-qualified investment" is defined in subsection 149.1(1) as:

(a) debt owing to the foundation by:

(i) any person who, (A) is a member, shareholder, trustee, settlor, officer, official or director of the foundation, (B) has, or who is a member of a group of persons who do not deal with each other at arm's length which group has, contributed more than 50 percent of the capital of the foundation, or (C) who does not deal at arm's length with any person described in (A) or (B), or

(ii) any corporation controlled by the foundation, any such person or group of persons, or by the foundation and any other foundation with which it does not deal at arm's length or by any combination thereof, or

(b) shares of any such corporation other than shares listed on a prescribed stock exchange.

Under section 189, where a private foundation owns a "non-qualified investment" the interest payable on the debt or dividends payable on the shares must be set at a specified (moving) level that relates to Canadian government interest rates. A failure to make payments at this level will trigger a tax on the corporate recipient of the loan or share subscription proceeds, and not on the private foundation.

The purpose of section 189 is to ensure that, where there is an investment from a private foundation to, for example, a family-controlled corporation, there is provision for a minimum flow of funds back to the foundation for use by the foundation to meet its disbursement quota obligations in the ITA.

New Monitoring, Reporting, and Excess Corporate Holding Rules under the *Income Tax Act* (Canada) for Private Foundations

New section 149.2 of the ITA introduced in December, 2007, establishes an excess corporate holdings regime for private foundations, namely by providing rules relating to the calculation of the divestment obligation percentage of a private foundation in respect of its excess holdings of shares of the capital stock of a corporation. These new rules are an attempt to address concerns regarding potential self-dealing opportunities for a private foundation and persons not dealing at arm's length with the foundation, and in view of the new favourable capital gains tax rules which apply to gifts of qualifying publicly-listed securities from any donor to a private foundation.

The new excess corporate holdings rules generally apply to taxation years of private foundations commencing after March 18, 2007, subject to certain transition rules which allow private foundations which have excess corporate shareholdings as of March 18, 2007, to come into compliance in an orderly manner. New section 149.2 sets out a regime that:

(a) limits a private foundation's shareholdings of a corporation;

(b) requires the foundation's shareholdings of all classes of any corporation to be monitored;

(c) increases the annual information return reporting requirements of the foundation's shareholdings;

(d) requires the foundation to report information regarding shareholdings; and

(e) requires shares to be divested (depending on the level of shareholdings of the foundation and those of relevant persons).

Subsection 149.1(1) introduces a definition of "relevant person" for the purpose of applying the excess corporate holdings regime. "Relevant person" is generally any person (including an individual, trust or corporation) that does not deal at arm's length with the private foundation (determined as if the foundation were a corporation). Non-arm's length persons include

individuals related to each other by blood, marriage, common-law relationship or adoption.

However, a relevant person does not include:

(a) a person that is considered not to deal at arm's length with a private foundation solely because of a right (other than the right whose exercise is contingent on the death, bankruptcy or permanent disability of an individual):

(i) to, or to acquire, shares or to control the voting rights of such shares;

(ii) to cause the corporation to redeem, acquire or cancel shares owned by the other shareholders;

(iii) to, or to acquire or control, voting rights in respect of shares; or

(iv) to cause the reduction of voting rights of shares owned by other shareholders; or

(b) an individual who:

(i) is 18 years or older;

(ii) lives separate and apart from an individual who controls or is a member of a related group that controls the private foundation; and

(iii) the Minister of National Revenue has agreed, after reviewing an application from the private foundation, is an individual that is dealing at arm's length with all controlling individuals.

The excess corporate holding rules are applied to each class of shares. They apply to all classes, irrespective of voting or other rights, held by the private foundation and are based on the size of shareholdings relative to the outstanding shares of each class. It is necessary that these rules be reviewed in detail. Generally speaking, however, where the private foundation owns 2 percent or less (an "insignificant interest") of any class of shares of a corporation, no action is required by the private foundation. Where a private foundation owns more than 2 percent of any class of shares of a corporation, the foundation will be subject to monitoring and reporting requirements in respect of "material interests" and "material transactions" (defined below). Where the foundation's shareholdings and the shareholdings of any relevant persons exceed 20 percent of the shares of any class of a corporation, the private foundation will be subject to mandatory divestiture rules and a penalty tax if the mandatory divestiture does not incur within a specified period of time.

A private foundation which has a divestment obligation in respect of any shares of a corporation at the end of any taxation year is subject to a penalty (subsection 188.1(3.1)) and can have its charitable status revoked (paragraph 149.1(4)(c)).

Under subsection 149.2(1), a person has a "material interest" in respect of a class of shares of a corporation if that person holds, (i) more than 0.5 percent of all issued and outstanding shares of that class, or (ii) shares with a fair market value that exceed $100,000.

"Material transaction" of a private foundation is defined in subsection 149.1(1) as a transaction or series of transactions or events in respect of shares of a class of a corporation if the fair market value of the shares of the class that are acquired or disposed of by the private foundation or by any relevant person at the time of the transaction or the end of the series of transactions exceeds the lesser of, (i) $100,000, and (ii) 0.5 percent of the total fair market value of all the issued and outstanding shares of the class.

Subsection 149.2(2) contains an anti-avoidance rule which provides that, if a private foundation or a relevant person has engaged in a series of transactions the purpose of which is to avoid the application of the definition of a material transaction, each of the transactions or series of transactions is deemed to be a material transaction.

Limitation Period for Demand Promissory Notes

By Greg Farano (reviewed by Stephen Thiele)

Although the Ontario *Limitations Act* (the "New Act") was passed in 2004, we continue to receive inquiries from clients regarding its application to, among other things, demand promissory notes. Demand promissory notes are often used in connection with tax-motivated transactions.

As a result of the New Act, and as confirmed in the 2006 decision of the Ontario Court of Appeal in *Hare v. Hare*, there is a two-year limitation period for bringing a claim under a demand promissory note which begins on the date the note is delivered by the borrower to the lender. This was a surprising result to some, as it was thought that, under the New Act, the two-year limitation period might begin on the date of demand under a demand promissory note.

The two-year limitation period is re-started, however, by the delivery within the two-year limitation period of a written, signed acknowledgment by the borrower to the lender of the borrower's liability under the note, or by the payment by the borrower within the two-year limitation period of any principal or interest due under the note.

In October, 2006, the New Act was amended to permit borrowers and lenders to, (i) suspend or extend the two-year limitation period in the case of all demand promissory notes, and (ii) exclude, or contract out of, the two-year limitation period entirely in the case of demand promissory notes that are "business agreements". This is discussed further below.

Background – The New Act and The Hare Decision

The New Act came into effect on January 1, 2004, and was an attempt at rationalizing what was previously a myriad, and sometimes difficult to interpret, set of limitation periods applicable to litigation claims in Ontario.

Subject to specific exceptions, the New Act reduced the limitation period for actions from 6 years to two years. Consequently and generally speaking, a lawsuit (including one to enforce a demand promissory note) must now be brought within two years from the date that the underlying "claim" was "discovered" or should have been "discovered". Otherwise, the ability to pursue an action with respect to a claim will be statute-barred - that is, an Ontario court will not consider it – if the claim is not made within the two-year limitation period. A "claim" is defined in the New Act as a "claim to remedy an injury, loss or damage that occurred as a result of an act or omission".

Under the New Act, the two-year limitation period begins on the day in which the "claim" is "discovered". One could argue that, in the case of a demand promissory note, a plaintiff only "discovers" that he or she is entitled to a remedy for an injury, loss or damage once demand for repayment of the note is made and the debtor defaults in payment. This position would seem to be consistent with the introduction in the New Act of a 15-year outside limitation period that begins, in the case of a default in performing a demand obligation, "on the day on which the default occurs".

Prior to the introduction of the New Act, it was clear under the common law that the limitation period for a demand promissory note began on the date the note was delivered by the borrower to the lender. It was thought though that the above feature of the New Act might change this common law rule.

However, the December, 2006, decision of the Ontario Court of Appeal in *Hare v. Hare*, (2006) 83 O.R. (3d) 766, held that the old common law rule continues to apply to demand notes. Accordingly, for loans made after January 1, 2004, the limitation period on a demand promissory note starts to run from the date the note is delivered to the lender.

The facts of this case are worth noting. In February, 1997, the plaintiff, Mary Hare, loaned $150,000 to her son, Brian Hare. Brian gave Mary a promissory note, with provision for payment of the $150,000 loan on demand together with interest at prime plus 1% per year. Brian's last payment was an interest payment made in October, 1998. In November, 2004, Mary made a demand for payment. Brian did not make the payment. Mary instituted a lawsuit for recovery of the debt in February, 2005. Brian defended the lawsuit arguing that the loan was barred by the predecessor *Limitations Act* (the "Former Act"), which the New Act replaced. Both the trial court and the Court of Appeal agreed with Brian (that Mary's lawsuit was statute-barred under the Former Act), and dismissed Mary's lawsuit.

The Court of Appeal stated that the law that a creditor has the right to an immediate payment of demand loan is well-settled. As the creditor under a demand note has the right to immediate payment, there is nothing to be "discovered" by the creditor before he or she becomes aware of the claim, which is established immediately upon receipt of the demand promissory note. Accordingly, Mary "discovered" her claim at the time the note was delivered to her by Brian (in February, 1997). Mary was in a position to enforce the note as of that delivery date. The Former Act applied, since the "discovery" occurred before January 1, 2004, and the 6-year limitation period under the Former Act expired before the commencement of Mary's lawsuit in February, 2005. The 6-year limitation period originally started at the time of the delivery of the note, in February, 1997, but was re-started by Brian's interest payment in October, 1998. The 6-year limitation therefore expired in October, 2004, just 4 months before Mary instituted her action against Brian.

Re-Starting the Limitation Period by "Acknowledgment"

As under the Former Act, by virtue of section 13 of the New Act an "acknowledgment" within the basic two-year limitation period by the borrower of a liability to a lender under a demand promissory note re-starts the running of the two-year limitation period. Such an "acknowledgement" may be in writing signed by the borrower or may occur simply by the payment of principal or interest by the borrower under the note. We suggest that a written acknowledgement be worded as follows, "The borrower hereby acknowledges and confirms that it is indebted to the lender as provided under the [credit agreement] [or] [promissory note] dated [date]". We also suggest considering the insertion of the following language into the body of a demand promissory note where interest and/or principal payments are required, "Payment of interest and/or principal from time to time hereunder shall be deemed to be an acknowledgement by the borrower of its continuing liability for the principal of and interest due under this note".

If a lender cannot obtain from a borrower a periodic (at least once every two years) written acknowledgment of the debt between them, the lender should insist on periodic (at least once every two years) interest and/or principal payments. Absent such a periodic written acknowledgement or an interest and/or principal payment (and where an extension, suspension, variation or exclusion of the limitation period has not occurred as set out below), a lender will have no choice but to institute, within the two-year limitation period, a legal claim against a borrower in a court of competent jurisdiction in order to preserve the lender's rights under a demand promissory note.

Suspending or Extending the Limitation Period – All Agreements

Pursuant to the recently amended subsection 22(3) of the New Act, lenders and borrowers may from and after October 19, 2006, and by agreement between them suspend (stop the running of) or extend the basic two-year limitation period. In our view such an extension of the two-year limitation period could be expressed

in a demand promissory note where the note is delivered by the borrower to the lender after October 19, 2006.

By virtue of subsection 22(4) of the New Act, lenders and borrowers may also from and after October 19, 2006, and by agreement between them suspend (stop the running of) or extend the 15-year outside limitation period (that sets an ultimate limit on claims even where other limitation periods in the New Act have not expired) where the relevant "claim" has been "discovered", that is where the demand promissory note has been delivered by the borrower to the lender. One could interpret this as permitting the insertion of a term suspending or extending the ultimate 15-year period in the promissory note itself. However, until the interpretation of this provision is clarified, we would recommend that any such extension be expressed by the borrower in a separate written acknowledgement signed by the borrower and delivered after the delivery of the demand promissory note.

Varying the Limitation Period - "Business Agreements"

Pursuant to the recently amended clause 22(5)1. of the New Act, lenders and borrowers may, from and after October 19, 2006, and where a demand promissory note between them is a "business agreement", agree to vary or exclude, that is contract out of entirely, the basic two-year limitation period. A "business agreement" is an agreement between parties none of which is a "consumer" as defined in the *Consumer Protection Act* (Ontario). "Consumer" is defined in the *Consumer Protection Act* (Ontario) as an individual acting for personal, family or household purposes, which does not include a person who is acting for business purposes. In our view such a variation or exclusion of the two-year limitation period could be expressed in the demand promissory note itself where the note is delivered by the borrower to the lender after October 19, 2006.

Pursuant to the recently amended clause 22(5)2. of the New Act, lenders and borrowers may, from and after October 19, 2006, and where a demand promissory note between them is a "business agreement", agree to "vary" (i.e. extend, shorten or suspend, but not exclude) the 15-year outside limitation period again where the relevant "claim" has been "discovered", that is where the demand promissory note has been delivered by the borrower to the lender. And again until the interpretation of this provision is clarified, we would recommend that any such extension be expressed by the borrower in a separate written acknowledgement signed by the borrower and delivered after the delivery of the demand promissory note.

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