

EFFECT OF INTER-CHARITY TRANSFERS ON DISBURSEMENT QUOTA CALCULATION UNDER BILL C-33

*By Theresa L.M. Man, B.Sc., M. Mus., LL.B.
and Terrance S. Carter, B.A., LL.B.*

A. INTRODUCTION

The Federal 2004 Budget released by the Department of Finance on March 23, 2004, included proposed amendments to the *Income Tax Act* (the “Act”)¹ in relation to the calculation of disbursement quota (“DQ”) by charities. Draft amendments to the Act implementing the March 2004 Federal Budget were released on September 16, 2004 (“September 2004 Amendments”),² and were further amended and consolidated on December 6, 2004 (“December 2004 Amendments”).³ Bill C-33, *A Second Act to Implement Certain Provisions of the Budget Tabled in Parliament on March 23, 2004* was passed by Parliament on February 25, 2005 and received first reading in the Senate on March 7, 2005. The new DQ rules are explained in *Charity Law Bulletin* Nos. 59 and 61,⁴ and summarized in both a table and flow chart format set out in *Charity Law Bulletin* No. 67.⁵ An explanation of the new DQ rules concerning transfers of gifts from registered charities

¹ R.S.C. 1985, c. 1 (5th Supp.).

² The September 2004 Amendments are explained in *Charity Law Bulletin* No. 54 dated October 29, 2004, *Charity Law Bulletin* No. 55 dated October 30, 2004, *Charity Law Bulletin* No. 56 dated October 31, 2004, and *Charity Law Bulletin* No. 59, dated November 26, 2004, all of which are available on our website at www.charitylaw.ca.

³ The December 2004 Amendments are explained in *Charity Law Bulletin* No. 61, dated January 12, 2005, available on our website at www.charitylaw.ca.

⁴ See footnotes 2 and 3.

⁵ See *Charity Law Bulletin* No. 67, dated March 31, 2005, available on our website at www.charitylaw.ca.

to charitable organizations,⁶ transfers of ten-year gifts, and transfers as a result of penalties⁷ is set out on pages 12 to 14 in *Charity Law Bulletin* No. 59 and in *Charity Law Bulletin* No. 61. This *Charity Law Bulletin* provides a review of the implications of DQ on both the transferor and the transferee charity as a result of transfers of property between charities under the new rules.

B. THREE CATEGORIES OF PROPERTY TRANSFERS

Under the new DQ rules, there are three categories of transfer of property between charities, namely specified gifts, enduring property (that has not been designated as specified gifts by the transferor charity) and other gifts which are neither enduring property nor specified gifts (which in the context of this *Charity Law Bulletin* are referred to as “ordinary gifts”⁸). The impact of each of the three categories of transfers on the DQ of the both the transferor charity and the transferee charity is explained below.

1. Transfer of ordinary gifts

Under the new DQ rules, a gift may be transferred as an “ordinary gift” between two charities. An ordinary gift is a gift of property where the transferor charity does not designate the gift as a specified gift and where the property is not an enduring property as defined in 149.1(1) of the Act.⁹ Pursuant to the new DQ rules, the transferor charity would be able to utilize the ordinary gift transferred to satisfy its DQ obligation in the taxation year in which the transfer is made. With respect to the transferee

⁶ Prior to the proposed amendments, only transfers from registered charities to public and private foundations are subject to the 80% disbursement quota, which mean that transfers from registered charities to charitable organizations are exempt from the 80% disbursement quota. The December 2004 Amendments propose that all transfers from one registered charity to another, including transfers to charitable organizations, will be subject to the 80% disbursement requirement. The only exceptions are transfers involving specified gifts and enduring property. This is achieved by applying variable “B” to charitable organizations. In the case of private foundations, variable “B” is the total of all amounts received by it in its immediately preceding taxation year from a registered charity, other than specified gifts or enduring properties. In the case of charitable organizations and public foundations, variable “B” is the same as the case for the private foundation, except that the inclusion rate is 80%, rather than 100%. These changes will apply to transfers received by charitable organizations in taxation years that begin after March 22, 2004.

⁷ Subsection 149.1(1.1) of the Act provides that a gift or expenditure made by a registered charity will not be considered in determining whether it has met its annual disbursement quota if the gift is made by way of a specified gift or if the expenditure is on political activities. Subsection 149.1(1) will be amended by the September 2004 Amendments, consequential to the amendment of Part V of the Act in respect of taxes and penalties for which the charity is liable under subsection 188(1.1) or section 188.1 of the Act. Now paragraph 149.1(1.1)(c) provides that a transfer to another registered charity under that Part does not qualify as an expenditure for the purposes of calculating the transferor’s disbursement quota. This amendment will apply in respect of notices of intention to revoke the registration of a charity and to notices of assessment issued by the Minister after the day that is 30 days after Royal Assent

⁸ The term “ordinary gift” is not a term under the Act but is used in this *Charity Law Bulletin* to refer to transfers of property that are neither specified gifts nor enduring property.

⁹ Transfers of specified gifts and enduring property are explained in the next two sections of this *Charity Law Bulletin*.

charity, the receipt of the ordinary gift would create a DQ obligation under variable “B” of the DQ formula. If the transferee charity is either a charitable organization or a public foundation, the transferee charity would be required to expend in the following taxation year 80% of the ordinary gift received. If the transferee charity is a private foundation, the transferee charity would be required to expend in the following year 100% of the ordinary gift received. [See Example 1]

Example 1: Transfer of an ordinary gift between charities

| Ordinary gifts (i.e. not specified gift, not enduring property) | Transferor charity | | Transferee charity | |
|--|--------------------|--|---|--|
| | DQ obligation | DQ satisfaction | DQ obligation | DQ satisfaction |
| Ordinary gift \$100 Charity A Charity B in year 1 | N/A | \$100 expended can be used to satisfy DQ obligation of Charity A in year 1 | <ul style="list-style-type: none"> • If Charity B is either a charitable organization or a public foundation: has to expend \$80 in year 2 • If Charity B is a private foundation: has to expend \$100 in year 2 (i.e. “B” in DQ formula) | N/A |
| When Charity B spends the \$100 in year 2 | N/A | N/A | N/A | \$100 expended can be used to satisfy DQ obligation in year 2 (must expend at least \$80 of the \$100 for a charitable organization or a public foundation and \$100 for a private foundation) |

2. Transfer of specified gifts

A “specified gift” is defined under subsection 149.1(1) of the Act as “that portion of a gift, made in a taxation year by a registered charity that is designated as a specified gift in its information return for the year.” Under the new DQ rules, a transferor charity that designates a gift to another charity as a specified gift is not permitted to utilize the transfer of the specified gift to satisfy its DQ obligation for the year because a specified gift is deemed not to be an expenditure on charitable activities or a gift made to a qualified donee pursuant to paragraph 149.1(1.1)(a) of the Act, and is therefore not included when calculating a charity’s DQ obligation. With respect to the transferee charity, the transfer does not create any DQ obligation because specified gifts are excluded under variables “A.1” and “B” of the DQ formula. When the transferee charity subsequently expends the specified gift it received, it would be able to utilize the expenditure of the specified gift to satisfy its DQ obligation. [See Example 2]

Example 2: Transfer of a specified gift between charities

| Specified gifts (includes enduring property received as specified gifts) | Transferor charity | | Transferee charity | |
|--|--------------------|--|---|---|
| | DQ obligation | DQ satisfaction | DQ obligation | DQ satisfaction |
| Specified gift \$100 Charity A Charity B in year 1 | N/A | --- | --- | N/A |
| | | Charity A cannot use the \$100 to satisfy its DQ obligation in year 1 (b/c 149.1(1.1)(a) exclusion of specified gifts) | Charity B is not obligated to expend any of the \$100 in year 2 (b/c specified gifts are excluded from A.1 and B of DQ formula) | |
| When Charity B spends the \$100 in year 2 | N/A | N/A | N/A | \$100 expended can be used to satisfy DQ obligation in year 2 |

3. Transfer of enduring property

Bill C-33 introduced a new concept of “enduring property” which is defined under subsection 149.1(1) of the Act to include the following:

- a) a gift received by a charity by way of a bequest or inheritance, including a gift deemed by subsection 118.1(5.2) or (5.3) of the Act;
- b) a gift received by a charitable organization from another registered charity, where the majority of directors and trustees of the donor charity deal at arm’s length with the recipient charitable organization, provided that the gift is subject to a trust or direction requiring that the gift be utilized over a period not exceeding five years in the course of a program of charitable activities or for the purpose of acquiring a capital property to be used directly in the charitable activities;¹⁰
- c) a ten-year gift received by a charity;¹¹ and
- d) a gift received by the charity as a transferee of an enduring property under (a) or (c) above from either an original recipient charity or another transferee charity, provided that if it is an enduring property under (c), the gift is subject to the same terms and conditions under the trust or direction.¹²

Due to a drafting error in the definition of the DQ in the Act prior to the proposed amendments, if a charity transfers a ten-year gift to another charity, the transferee charity has to expend 80% of the ten-

¹⁰ This paragraph was not included in the September 2004 Amendments, but was inserted in December 2004.

¹¹ Enduring property includes a ten-year gift received by a charity (i.e. the “original recipient charity”) with the gift, or property substituted for the gift, subject to a trust or direction that the property is to be held by the original recipient charity or by another registered charity (i.e. “transferee”) for a period of not less than 10 years from the date the original recipient charity received the gift, except that the trust or direction may permit the original recipient charity or the transferee to expend the property before the end of 10 years to the extent permitted under variable “B.1” of the definition for disbursement quota in order to meet the disbursement quota requirement (In December 2004, this paragraph was revised to clarify that paragraph (c) does not deal with gifts received from another registered charity).

¹² The English version of the amendments proposed in December 2004 erroneously made reference to paragraph (b) instead of (c). However, the French version is correct. It is anticipated that this error will be corrected by a technical bill to be introduced at a later time.

year gift in the year following the transfer of the gift. In order to avoid the recipient charity having to include the amount it received in its DQ and having to expend 80% of the amount in the following year, the recipient charity is required to recognize the amount received as a specified gift. However, in order for the amount transferred to be recognized as a specified gift, the amount has to be designated as such by the transferor charity. The disposition of the property as a specified gift by the transferor charity means that the transferor charity is not permitted to include the amount transferred in meeting its DQ obligation created by the transfer itself. To overcome this difficulty, the transferor charity or the transferee charity would have to obtain relief from CRA by applying for dispensation from the application of the DQ under subsection 149.1(5) of the Act.

In order to address this anomaly, the September 2004 Amendments propose to exempt the transfer of enduring property from variable “B”. The effect of this would be that a gift of enduring property received by a charity would not need to be included in the DQ of the transferee charity. This exemption, therefore, would not require the enduring property received be expended in the following year by the transferee charity. With respect to the transferor charity, this anomaly is proposed to be resolved in the September 2004 Amendments by a new variable “A.2”, which is defined in paragraph 149.1(1) to mean the fair market value (at the time of the transfer) of enduring property (other than enduring property that was received by the charity as a specified gift) transferred by a charity in the taxation year by way of a gift to a qualified donee. In December 2004, variable “A.2” was removed and a new subparagraph (a)(ii) was inserted in the definition for “A.1” to include the fair market value of enduring property transferred by the charity in the year by way of gift to a qualified donee (which does not include enduring property that was received by the charity as a specified gift). The new subparagraph (a)(ii) is the same as the definition for “A.2” that was removed in December 2004. This amendment means that the amount formerly determined under “A.2” in the September 2004 Amendments will also become eligible for capital gains reduction. In this regard, the Explanatory Notes indicate that a different disbursement requirement applies for an enduring property that is expended by way of gift to a qualified donee. The charity must disburse 100% of such an amount (which requirement is satisfied by the gift itself). This means that the transferor charity would be able to include the amount of enduring property it transfers to a qualified donee in order to meet its DQ obligation, which would off-set the increase in

DQ of the transferor charity as a result of disposing of the enduring property to the qualified donee. This proposal also applies to taxation years after March 22, 2004.

In summary, under the new DQ rules, when a charity transfers an enduring property to another charity (and does not designate the enduring property as a specified gift), the transfer would create a DQ obligation on the transferor charity to expend 100% of the value of the property in the year of the transfer under variable “A.1(a)(ii)” of the DQ formula. This DQ obligation on the transferor charity would be satisfied by the transfer itself, i.e. the transferor charity would include this transfer in satisfying its DQ obligation for the year. With respect to the transferee charity, the receipt of the enduring property would not create a DQ obligation on the charity, because enduring property is not included in variable “B” in the DQ formula. Upon the subsequent expenditure of the enduring property by the transferee charity, the expenditure will create a DQ obligation on the charity so that it is required to expend 80% of the enduring property in the year under variable “A.1(a)(i)” of the DQ formula. The expenditure itself would be utilized to satisfy the DQ obligation of the charity in the year. [See Example 3]

Example 3: Transfer of an enduring property between charities

| Enduring property | Transferor charity | | Transferee charity | |
|---|---|---|---|---|
| | DQ obligation | DQ satisfaction | DQ obligation | DQ satisfaction |
| Enduring property \$100 Charity A Charity B (provided that the property was not received as a specified gift) | Charity A will be required to expend 100% of the fmv of the enduring property (i.e. \$100 in this case) in year 1 under A.1(a)(ii) in DQ formula, | \$100 expended can be used to satisfy DQ obligation in year 1 (which would in and of itself satisfy the DQ obligation created by making the gift under A.1(a)(ii) in DQ formula | --- no effect on DQ (b/c EP is exempt from B in DQ formula) | --- no effect on DQ until such time as Charity B expends the gift |
| | Net effect = DQ neutral for transferor charity | | | |
| When Charity B expends the \$100 in year 2 | N/A | N/A | Charity B will be required to expend at least \$80 in year 2 (i.e. A.1(a)(i) in DQ formula) | \$100 expended can be used to satisfy the DQ obligation in year 2 (which would in and of itself satisfy the DQ obligation created by making the gift under A.1(a)(i) 2), in DQ formula (must expend at least \$80 of the \$100) |

If the enduring property being transferred was designated by the transferor charity, either inadvertently or purposefully, as a specified gift, such a designation would not cause any negative effect on the DQ obligation of the transferee charity because variables “A.1” and “B” exempt specified gifts received from being included in the transferee charity’s DQ. However, the transfer itself would create a DQ obligation on the transferor charity in the year of the transfer under variable “A.1(a)(ii)” of the DQ formula, because the expenditure of a specified gift is not exempt from variable “A.1(a)(ii).” However, the transferor charity would not be able to use the transfer itself to satisfy the DQ obligation, including the DQ obligation created by this transfer, because it is transferred as a specified gift.¹³ This means that the transferor charity would need to utilize other expenditures in the year to satisfy both the DQ obligation created by this transfer and its other DQ obligation. [See Example 4]

Example 4: Transfer of an enduring property designated as a specified gift between charities

| Enduring property | Transferor charity | | Transferee charity | |
|---|--|---|--|---|
| | DQ obligation | DQ satisfaction | DQ obligation | DQ satisfaction |
| Enduring property \$100 If Charity A Charity B but Charity A designates it as specified gift | Charity A will be required to expend \$100 in year 1 under A.1(a)(ii) in DQ formula | --- Charity A cannot use the \$100 to satisfy its DQ obligation in year 1 (b/c 149.1(1.1)(a) exclusion of specified gifts) | --- Charity B is not obligated to expend any of the \$100 in year 2 (b/c specified gifts are excluded from A.1 and B of DQ formula) | N/A |
| | By designating the transfer as a specified gift, Charity A will have to meet the A.1 DQ obligation created by this transfer with other expenditure | | | |
| When Charity B spends the \$100 in year 2 | N/A | N/A | N/A | \$100 expended can be used to satisfy DQ obligation in year 2 |

C. FACTORS TO CONSIDER IN CATEGORIZING INTER-CHARITY TRANSFERS

Since different categories of transfer impact the DQ obligation and DQ satisfaction of the transferor charity and the transferee charity differently, in deciding how to categorize a transfer of assets from one charity to another charity, the following questions would need to be asked:

Question (1) : Is the property an enduring property?

¹³ See explanation above concerning transfers of specified gifts.

Question (2) : Does the transferor charity require the disbursement to satisfy its DQ obligation for this year and/or DQ shortfall from prior years?

If the answer to question (1) above is “no,” and if the answer to question (2) is “yes,” then the transferor charity would want to transfer the property as an ordinary gift, not as a specified gift, in order to be able to utilize the transfer to satisfy its DQ obligation. However, the transferee charity would need to include the transfer in its DQ obligation for the following year. If, however, the transferor charity transfers the property as a specified gift, the transferor charity cannot use the transfer to satisfy its DQ obligation for the year and the transfer does not create any DQ obligation for the transferee charity.

If the answers to both questions (1) and (2) above are “no,” then the transferor charity may choose to transfer the property either as an ordinary gift or as a specified gift. If the property is transferred as an ordinary gift, and since the transferor charity does not need to include the transfer in order to satisfy its DQ obligation for the year, the transfer will lead to a DQ excess for the transferor charity for use in future years. The transferee charity would need to include the transfer in its DQ obligation for the following year. If the property is transferred as a specified gift, the transferor charity cannot use the transfer to satisfy its DQ obligation for the year, which is not problematic for the transferor charity since its response to (2) is “no.” The transfer would not create any DQ obligation for the transferee charity.

If the answer to question (1) above is “yes” and if the transferor charity transfers the enduring property to the transferee charity, the transfer would create a DQ obligation on the transferor charity, which DQ obligation will be satisfied by the transfer itself. If the answer to question (2) is “yes,” the transfer would not be of benefit to the transferor charity in relation to the satisfaction of its other DQ obligation because the transfer would be utilized to satisfy the DQ obligation by the transfer itself. In relation to the transferee charity, the transfer would not affect its DQ obligation until it is expended by the transferee charity.

If the answer to question (1) above is “yes” and if the transferor charity transfers the enduring property as a specified gift to the transferee charity, the transfer itself would create a DQ obligation on the transferor charity in the year of the transfer and the transferor charity would not be able to use the transfer itself to satisfy the DQ obligation created by this transfer or any other DQ obligation of the transferor charity (i.e. if the answer to question (2) is “yes”). This means that the transferor charity would need to use other

expenditure in the year to satisfy both the DQ obligation created by this transfer and its other DQ obligation. The transfer does not create any DQ obligation for the transferee charity.

D. CONCLUSION

The impact on the DQ of the transferor charity and the transferee charity is different depending on the category of property transferred between the charities, whether as specified gifts, enduring property (not designated as specified gifts by the transferor charity) or ordinary gifts. It is, therefore, important for charities and their advisors to be aware of how the three categories of transfer will affect the DQ calculation in order to ensure that transfers do not lead to unintended results.