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CALCULATION OF 3.5% DISBURSEMENT QUOTA FOR ALL REGISTERED CHARITIES

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A. INTRODUCTION

On November 28, 2008, Canada Revenue Agency ("CRA") published a reminder indicating that the 3.5% disbursement quota will apply to charitable organizations registered before March 23, 2004, for their fiscal period beginning on or after January 1, 2009.[1] Since these charitable organizations may not be familiar with how the 3.5% disbursement quota is calculated, this *Charity Law Bulletin* explains how to calculate the 3.5% disbursement quota.[2]

All registered charities are required to expend a portion of its assets annually in accordance with a disbursement quota, which is a prescribed amount that registered charities must disburse each year in order to maintain their charitable registration. The purpose of the disbursement quota is "to ensure that most of a charity's funds are used to further its charitable purposes and activities; to discourage charities from accumulating excessive funds; and to keep other expenses at a reasonable level."[3] Having a good understanding of the disbursement quota rules is important not only for charities, but also for donors and their advisors. The source of the gift, the nature of the proposed recipient charity, the nature of the property gifted, and restrictions that may be imposed on the gift by the donor will all have a bearing on the disbursement quota consequences of the gift.

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[1] The reminder is available on CRA's website at http://www.cra-arc.gc.ca/tx/chrts/whtsnw/dbqt-eng.html.

[2] Portions of this bulletin are based on a paper by Theresa L.M. Man and M. Elena Hoffstein , "New Disbursement Quota Rules Under Bill C-33" (2007) vol. 20. No. 4, *The Philanthropist* 294.

[3] See Canada Revenue Agency, *Information Circular* RC 4108, "Registered Charities and the Income Tax Act," updated May 7, 2002, available at http://www.cra-arc.gc.ca/E/pub/tg/rc4108/rc4108-02e.pdf.

B. BACKGROUND OF THE 3.5% DISBURSEMENT QUOTA

By way of background, new disbursement quota rules were enacted by Parliament on May 13, 2005, upon the passage of Bill C-33,[4] as a result of proposals contained in the 2004 Federal Budget released on March 23, 2004. All registered charities are required to comply with an 80% disbursement quota, which is generally equal to 80% of receipted gifts and gifts received from other registered charities in the immediately preceding year (except gifts of capital received by way of bequest or inheritance, 10-year gifts and specified gifts received from other registered charities). However, prior to the enactment of Bill C-33 in 2005, only public and private foundations (but not charitable organizations) were subject to the 4.5% disbursement quota on assets not used directly in charitable activities or administration.

In addition to reducing the 4.5% disbursement quota to 3.5%, Bill C-33 amended the *Income Tax Act* (Canada)[5] (the "Act") by expanding the application of the reduced 3.5% disbursement quota to charitable organizations. The reason for this, as stated in the 2004 Federal Budget, is that while historically charitable foundations were the primary beneficiaries of endowments, both charitable organizations and foundations today can and do hold endowments from which investment income is generated. The Department of Finance was concerned that if charitable organizations were not subject to the 3.5% disbursement quota, this investment income would not be subject to any disbursement quota obligation. For charitable organizations registered after March 22, 2004, the 3.5% disbursement quota applies to their taxation years that begin after March 22, 2004. For charitable organizations registered before March 23, 2004, the 3.5% disbursement quota will apply to their taxation years that begin on or after January 1, 2009.

As a result of the application of the 3.5% disbursement quota to charitable organizations, concerns were raised in the charitable sector regarding the ramifications of the application of this requirement on small charitable organizations. In response to this concern, the reduced 3.5% disbursement quota applies to all registered charities (including charitable organizations, public foundations, and private foundations) only if the amount of their investment assets is greater than $25,000. Since foundations have always been required to satisfy the 4.5% disbursement quota (now 3.5%), it is not clear why the *de minimis* threshold of $25,000 would also apply to them. However, despite the Department's attempt to relieve hardship that may be faced

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[4] *A Second Act to Implement Certain Provisions of the Budget Tabled in Parliament on March 23, 2004*. (*Budget Implementation Act, 2004, No. 2*) R.S.C., 2005, c. 19.
[5] R.S.C. 1985, c. 1 (5th Supp.), as amended.

by small charitable organizations, there is still concern that the threshold of $25,000 is too low and therefore would not be of assistance to them.

Failure by a charity to comply with the disbursement quota may result in its charitable registration being revoked.[6] In practice, however, de-registration is not likely to occur unless there have been continuous failures to meet the disbursement quota. Apart from de-registration, the Act provides two ways of dealing with disbursement shortfalls. First, disbursement excesses from the preceding five taxation years and/or from the immediately subsequent taxation year may be applied against disbursement shortfalls. Second, a charity may apply to have its disbursement quota reduced for the particular taxation year.[7] Other than de-registration, Bill C-33 also provides that transfers among charities to avoid disbursement quotas may result in a penalty of 110% of the fair market value of property transferred, with the transferor and transferee charities being jointly and severally liable for the penalty.[8]

C. CALCULATION OF THE 3.5% DISBURSEMENT QUOTA

The detailed method for the calculation of the 3.5% disbursement quota is set out in Regulations 3700, 3701, and 3702 of the *Income Tax Regulations*. The calculation of the 3.5% disbursement quota is based on the average value of property owned by the charity, which was not used directly in charitable activities or administration, in the 24 months before the beginning of the fiscal period in question. For charitable organizations registered before March 23, 2004, they must know that value for 2007 and 2008 when calculating the 3.5% disbursement quota for the fiscal year 2009. The average value is recorded on a charity's annual information return, Form T3010B,[9] on line 5900. However, if the average value of the charity's property not used for charitable activities or administration is $25,000 or less, the charity does not have to calculate the 3.5% disbursement quota.

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[6] Paragraphs 149.1(2)(b), (3)(b) and (4)(b) of the Act.

[7] Subsection 149.1(5) of the Act. This requires that the charity make an application in prescribed form (Form T2094). Such an application will be successful only if (1) the charity has used its disbursement excess from prior years and (2) the disbursement shortfall is due to extraordinary circumstances beyond the charity's control (See CRA Summary Policy CSP-D03, dated October 25, 2002, and Information Letter CIL-1996-001, January 15, 1996, CIL-2001-002, January 16, 2001, and CIL-2002-002, February 19, 2002). Moreover, such a relief would only be granted for the purpose of allowing a charity to correct a deficiency in meeting its disbursement quota, and would not be granted for an indefinite period (See CRA Information Letter CIL-2001-002 January 16, 2001).

[8] Subsection 188.1(11) of the Act.

[9] A new T3010B will be released by CRA in January 2009, and be used when filing annual information returns for fiscal periods ending on or after January 1, 2009. See CRA's publication released on November 28, 2008 on CRA's website at http://www.cra-arc.gc.ca/tx/chrts/whtsnw/crrc-eng.html.

1. Number of periods

In order to calculate the 3.5% disbursement quota, it is necessary to divide the 24 months immediately preceding the fiscal period in question into 2 to 8 equal and consecutive periods. The value of the assets is an average value based on the number of periods so chosen. The number of periods to be chosen will depend on the accounting method and the type of property the charity holds. Usually, the number of periods is chosen the first time when the charity files its first annual information return. In the case of charitable organizations to which the 3.5% disbursement quota begins to apply for the fiscal year beginning in 2009, they will need to choose the appropriate number of periods when they file their T3010B for their 2009 fiscal period. Once the number of periods is chosen, CRA's approval will be required in order to change it in the future.

Once the number of periods has been chosen, the charity will need to determine the value of its assets not used directly in charitable activities or administration at the end of each period, aggregate them and divide it by the number of periods chosen. The 3.5% disbursement quota will be 3.5% of the result thus calculated.

The charity should be careful in choosing the number of periods the first time, because it may affect the amount of the 3.5% disbursement quota to be expended for various reasons.

First, the number of periods chosen may affect the ability of the charity to take into account changes in the market value of the assets during the 24 month period when calculating the 3.5% disbursement quota. For example, if a charity chooses 2 periods, it will need to calculate the value of its assets once a year at the end of each 12-month period. While the charity would only need to valuate its assets once a year, the charity would not be able to take into account changes in the value of the assets during the 12-month period. For example, if the market was particularly strong during the 12th month and therefore resulting in an unusually high value at the end of the 12th month, this may result in a higher 3.5% disbursement quota. Instead, if the charity were to choose 8 periods, it will need to calculate the value of its assets once every three months. While this may require more administration for the charity in monitoring the value of its assets on a quarterly basis, the resultant 3.5% disbursement quota calculated would better reflect the change in the market value of the assets over the 24-month period.

Second, the number of periods chosen may reduce the amount of the 3.5% disbursement quota for charities that do not have investment assets during a portion of the 24 month period. Take for example, a charitable organization that was registered on January 1, 2004, with fiscal year end being December 31, and not having any investment assets until June 1, 2008. This charity will need to begin complying with the 3.5% disbursement quota in its 2009 fiscal year. Its 3.5% disbursement quota for 2009 is based on the value of its investment assets for the 24-month period from January 1, 2007 to December 31, 2008. Assume that the charity holds investment assets in the amount of $100,000 on June 1, 2008, which value remains unchanged until December 31, 2008. If the charity chooses 2 periods, the value of the assets would be $0 on December 31, 2007 and $100,000 on December 31, 2008. The 3.5% disbursement quota will be $1,750 (being $0 + $100,000, divided by 2, and multiplied by 3.5%). If the charity chooses 8 periods, the value of the assets would be $0 for the first 5 periods, and $100,000 for the last 3 periods, being June 30, 2008, September 30, 2008 and December 31, 2008. The resultant 3.5% disbursement quota will be $1,312.5 (being $0 + $0 + $0 + $0 + $0 + $100,000 + $100,000 + $100,000, divided by 8, and multiplied by 3.5%). Therefore, the higher the number of periods, the lower the 3.5% disbursement quota would be in this fact scenario.

2. Assets and valuation

The assets upon which the 3.5% disbursement quota is calculated include those assets that are not used directly in charitable activities or administration and will include all real estates and personal property, such as cash on hand and in bank accounts, stocks, bonds, term deposits, mutual funds, as well as lands and buildings.[10] If, for example, 25% of a building is used in the charity's charitable activities or administration, then only 75% of the value of the building would need to be included in the 3.5% disbursement quota calculation.

Regulation 3702 provides specific rules in determining the value of the assets. In this regard, the value of an asset is generally the fair market value of the property on the last day of a period.[11] However, the value of a publicly-listed share is the closing price or the average of the bid and asked prices of that share on that day or, if there is no closing price or bid and asked prices on that day, on the last

[10] See CRA guide T4033A "Completing the Registered Charity Information Return" available on CRA's website at http://www.cra-arc.gc.ca/E/pub/tg/t4033a/t4033a-e.html.
[11] Regulation 3702(b)(vii).

preceding day for which there was a closing price or bid and asked prices.[12] The value of an interest in a real property is the fair market value of the interest on that day, less the amount of any debt incurred in respect of the acquisition of the interest and secured by the real property, where the debt bears a reasonable rate of interest.[13] Regulation 3702 also set out rules on how other types of assets are to be determined.

D. CONCLUSION

Based upon the above, it is important that all registered charities be familiar with the method by which the 3.5% disbursement quota is to be calculated. This is specially the case for charitable organizations that were registered before March 23, 2004. Furthermore, registered charities should be careful in choosing the number of periods for the 24 months that apply to the calculation. Where the charity is not clear on how the 3.5% disbursement quota is to be calculated, legal and accounting advice should be sought.

[12] Regulation 3702(b)(i).
[13] Regulation 3702(b)(iii).

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