CARTERS.ca

Carters Professional Corporation / Société professionnelle Carters
Barristers, Solicitors & Trade-mark Agents / Avocats et agents de marques de commerce

CHARITY LAW BULLETIN NO. 171

JULY 29, 2009
REVISED AUGUST 5, 2009
Editor: Terrance S. Carter

ENDURING PROPERTY AND THE DISBURSEMENT QUOTA

By Theresa L.M. Man[*]

A. INTRODUCTION

The term "enduring property" was introduced in the 2004 federal budget (which became law in 2005) and has a substantial impact on the calculation of the disbursement quota of charities and the ability of charities to encroach on ten-year gifts to meet its 3.5% disbursement quota.[1] Since the introduction of this term and other new rules on the disbursement quota, there have been many questions from the sector on the treatment of enduring property for disbursement quota purposes. On April 20, 2009, Canada Revenue Agency ("CRA") released a document entitled "Treatment of Enduring Property for Purposes of the Disbursement Quota" (the "CRA Document"),[2] setting out answers to nine frequently asked questions on this issue. Instead of repeating these nine questions and answers, which are self-explanatory, this article explains what an enduring property is and reviews principles that apply to how enduring property is treated for disbursement quota purposes,[3] as clarified by CRA's questions and answers. Once the principles are understood, they can be applied to different scenarios.

[*] Theresa L.M. Man, B..Sc., M.Mus., LL.B., LL.M., is a partner with Carters Professional Corporation.
[1] The 2004 federal budget was released in March 2004. Draft amendments to the *Income Tax Act* (Canada) were released on September 16, 2004, which were revised on December 6, 2004. The proposed amendments were introduced as Bill C-33, which was enacted on May 13, 2005 as the *Budget Implementation Act, 2004, No. 2*., R.S.C., 2005, c. 19.
[2] Available on CRA's website at http://www.cra-arc.gc.ca/tx/chrts/plcy/csp/csp-e10-fqs-eng.html.
[3] A portion of this Bulletin is based on a paper by M. Elena Hoffstein and Theresa L.M. Man, "New Disbursement Quota Rules under Bill C-33," *The Philanthropist*, Vol 20, No. 4, pp. 294-332 (online: www.charitylaw.ca).

B. WHAT IS AN ENDURING PROPERTY?

The term "enduring property" is defined in section 149.1(1) of the *Income Tax Act* (Canada) (the "Act"). Enduring property includes four types of properties.

First, an enduring property includes gifts received by a charity by way of bequest or inheritance (including life insurance proceeds, RRSPs, and RRIFs by direct beneficiary designation). Second, an enduring property includes "ten-year gifts" received by a charity from a donor, as explained further below. Third, an enduring property includes a bequest/inheritance or a ten-year gift that has been transferred from the charity that originally received them to another charity. In other words, when a bequest/inheritance or a ten-year gift is transferred from one charity to another, the property would continue to be tracked as an enduring property.

Fourth, an enduring property includes gifts received by a charitable organization (but not a foundation) from another registered charity, where (1) the majority of directors and trustees of the donor charity deal at arm's length with the recipient charitable organization, (2) the gift is subject to a trust or direction requiring that the gift be utilized within five years, and (3) the gift must be used to acquire tangible capital property to be used directly in the recipient charity's charitable activities or administration, or to be used in a charitable activity that could not reasonably be completed within one year after having received the gift. This type of enduring property is sometimes referred to as "five-year gifts."

C. TEN-YEAR GIFTS

A ten-year gift is a gift that is subject to a trust or direction imposed by the donor, requiring the gift (or property substituted for the gift) be held by the charity for a period of time that is at least ten years from the date when the gift was made (the "hold period"). If this charity transfers the ten-gift to another charity during the hold period, the said trust or direction would also be binding on the transferee charity. The Act also allows the trust or direction to permit the original charity or the transferee charity to expend the ten-year gift before the end of the hold period to the extent of an amount determined for the charity's 3.5% disbursement quota. CRA repeatedly stressed in a number of its responses in the CRA Document that in order to qualify as a ten-year gift, the trust/direction must restrict the encroachment up to the charity's 3.5% disbursement quota.

It is necessary for a charity to track each ten-year gift separately in order to determine when the hold periods in each case would expire. This is confirmed by CRA's answer to question 4 in the CRA Document. This tracking is necessary in all situations, even though it is possible that a charity's endowment fund may consist of various ten-year gifts donated at different points in time and it is possible for donors to impose different hold periods to each of these ten-year gifts. For example, a donor, John Doe, donates $100,000 to a named John Doe Fund in year 1 and instructs the charity to not to disburse the gift for 20 years; then the donor's son donates another $5,000 to the John Doe Fund in year 3 and requires the charity to hold the gift for 15 years. Both of these gifts are ten-year gifts. However, the charity may not disburse the capital of the first gift until year 21, but the charity may disburse the capital of the second gift in year 18.

D. 80% AND 3.5% DISBURSEMENT QUOTA

An enduring property is generally excluded from the 80% disbursement quota (under A of the formula for calculating disbursement quota[4]) in the year it is received. This means that the charity would not be required to expend 80% of the enduring property in the following year. However, the enduring property would be included in calculating the charity's disbursement quota (under A.1 of the formula for calculating disbursement quota) in the year in which it is spent or transferred to a qualified donee. In this regard, CRA clarified in its response to question 7 in the CRA Document that enduring property expended in a taxation year will impact the charity's disbursement quota requirement in the *same* taxation year in which the property is expended, but it would not create an 80% disbursement quota requirement in the *following* year.

Specifically, this means that upon the expenditure of an enduring property, the expenditure will create a disbursement quota obligation on the charity so that it is required to expend 80% of the enduring property in the year of the expenditure (not the following year) under A.1(a)(i) of the disbursement quota formula. The disbursement quota obligation so created would be met by the expenditure itself in that same year.

If, instead of expending an enduring property on the charity's charitable programs, the enduring property is transferred to a qualified donee (e.g. another registered charity), then the transfer would create a 100% disbursement quota in the year under A.1(a)(ii) of the disbursement quota formula, which would also be met by the transfer itself. With respect to the transferee charity, the receipt of the enduring property would not create a disbursement quota obligation on the charity because enduring property is not included in B in the

[4] See definition for "disbursement quota" in subsection 149.1(1) of the Act.

disbursement quota formula. However, the enduring property would create a disbursement quota obligation when it was subsequently expended or transferred to a qualified donee.

When an enduring property is not used directly in the charity's charitable activities or administration (where a ten-year gift is invested by the charity during the hold period), it would need to be included in the charity's 3.5% disbursement quota calculation.[5]

E. ENCROACHMENT OF TEN-YEAR GIFTS AND CAPITAL GAINS POOL

1. Donor permission for encroachment and capital gains pool

It is possible for a ten-year gift to be subject to a trust or direction to permit the original recipient charity (or a subsequent transferee charity) to expend the ten-year gift before the end of the specified hold period to the extent of an amount determined for the charity's 3.5% disbursement quota. In other words, where a ten-year gift is not subject to a donor's trust or direction permitting encroachment, it would not be permissible to encroach on the ten-year gift at all. This is confirmed in CRA's response to question 2 in the CRA Document.

As long as the encroachment on a charity's ten-year gifts does not exceed what is in the charity's "capital gains pool," the Act permits the entire amount encroached to be applied towards meeting the charity's 3.5% disbursement quota. The capital gains pool is a notional account of all realized capital gains derived from the disposition of a charity's enduring property. This is effected by allowing a charity to reduce the 80% disbursement quota obligation in A.1 of the disbursement quota (as explained above) by an amount claimed by the charity that does not exceed the lesser of 3.5% disbursement quota and the charity's capital gains pool.

Since a donor's trust/direction may allow a charity to encroach on a ten-year gift up to 3.5% of the disbursement quota, it is conceptually possible that the encroachment on a ten-year gift for the purpose of meeting its 3.5% disbursement quota may in fact exceed what is in the charity's capital gains pool. However, in that situation, the encroachment that is beyond the capital gains pool (the "excess

[5] For an explanation of the calculation of the 3.5% disbursement quota, see Theresa Man, *Charity Law Bulletin* No. 150, "Calculation of 3.5% Disbursement Quota for all Registered Charities", December 18, 2009, at http://www.carters.ca/pub/bulletin/charity/2008/chylb150.pdf.

amount") would be included in A.1 of the disbursement quota and therefore create a disbursement quota obligation on the charity. The charity would thus be required to expend 80% of the excess amount in the year under A.1(a)(i) of the disbursement quota formula, which disbursement quota obligation so created would be met by the expenditure itself in that same year. This would only leave 20% of the excess amount available towards meeting the 3.5% disbursement quota.[6]

Capital gains from the disposition of *all* enduring property can be included in the capital gains pool, including bequest and inheritance, ten-year gifts and five-year gifts, as explained above. However, the Act states that capital gains from a disposition of a bequest or inheritance received by the charity before 1994 cannot be included.

A charity would also need to be careful with the type of encroachment permitted by the donor's trust and direction in order to ensure that the permission would not jeopardize the donated property being qualified as a ten-year gift. The trust/direction must limit the encroachment to meeting the charity's 3.5% disbursement quota. In situations where the trust/direction permits a charity to encroach on capital to cover its administration fees and investment management fees, this is permissible provided that the trust/direction restricts the encroachment for such fees up to the charity's 3.5% disbursement quota. However, if the permitted encroachment is not limited to such a cap, CRA's response to question 6 in the CRA Document indicates that the gift would not qualify as a ten-year gift in the first place. In other words, in order to qualify as a ten-year gift, the trust/direction must restrict the encroachment up to the charity's 3.5% disbursement quota. Furthermore, CRA clarified in question 6 that any encroachment on capital will factor into the disbursement quota calculation and that amounts spent on administration and investment management fees are not charitable expenditures and cannot be used to satisfy the disbursement quota.

[6] For example, a charity is short $5,000 in meeting its 3.5% disbursement quota. It has $4,000 in its capital gains pool. The charity encroaches $5,000 from its ten-year gifts. The charity would have to include $5,000 in its A.1 disbursement quota formula, but it is entitled to claim a reduction of $4,000 (the amount in the capital gains pool). Therefore, the encroachment would create an 80% disbursement quota obligation on the remaining $1,000, i.e. $800, to be met in that year. After applying the $5,000 encroachment towards meeting the $800 disbursement quota obligation, only $4,200 would be available towards meeting the charity's 3.5% disbursement quota, leaving it still short $800. In other words, only $4,000 of the $5,000 would have the full benefit of being applied towards meeting the charity's 3.5% disbursement quota, with only 20% of the remaining $1,000 being available to meeting the 3.5% disbursement quota, leaving a shortfall of $800.

The Act is silent in relation to the encroachment of bequests and inheritance because such issues would be governed by the terms of the testamentary instruments creating such gifts.

2. Charity's discretion to encroach

A charity can decide *when* and *whether* to encroach on its ten-year gifts in order to meet its 3.5% disbursement quota, and if there is an encroachment, *how much* to encroach.[7] CRA's response to question 5 in the CRA Document clarified that even where a charity has disbursement excess, the charity has the discretion to encroach on the ten-year gifts in meeting its 3.5% disbursement quota, provided that the terms of the ten-year gift permits encroachment.

3. Realized capital gains and notional account

It is important to note that the capital gains pool consists only of capital gains *realized* on the disposition of enduring property. Unrealized capital gains are not included. Since only realized capital gains are included in the capital gains pool, in some circumstances it may be beneficial for a charity to dispose of its investment assets at a time when the market is high in order to maximize the amount of realized capital gains in the pool available for future encroachment when required.

The capital gains pool is a *notional account* of all realized capital gains derived from the disposition of enduring property. As such, just because amounts are tracked in the notional account of the capital gains pool, this does not necessarily mean that funds are available for disbursement, especially in situations where there is a loss in the value of an enduring property as a result of a down turn in the market.

4. Tracking of capital gains pool and declaration in T3010

Charities should declare its capital gains pool in its annual T3010 Information Return. The Explanatory Notes to Bill C-33 indicate that that "annual calculation of additions to and deductions from the capital gains pool is voluntary; however, it may be of benefit to a charity to make this calculation if it expects to ever claim a reduction of its disbursement quota in respect of the expenditure of enduring property." In other words, regardless of whether a charity expects to utilize its capital gains pool in the year, it

[7] This is because of the phrase "an amount claimed by the charity" in A.1(b) of the disbursement quota formula.

should make its annual calculation and declare such amount on an annual basis on its T3010 Information Return in order to be able to utilize its capital gains pool if and when it wishes to do so in the future.

In CRA's response to question 3 in the CRA Document, CRA indicated that if a charity does not track its capital gains pools, it will inhibit its ability to encroach on enduring property. CRA explained that tracking the capital gains pool allows a charity to reduce its 80% disbursement quota obligation under A.1 of the disbursement quota formula (i.e., enduring property spent or transferred to a qualified donee in a taxation year). Therefore, if a charity does not track its capital gains pools, it will be unable to determine the amount of the reduction that it is entitled to. As such, while the annual calculation of the capital gains pool is voluntary, CRA recommended that charities declare their capital gains realized on the disposition of enduring property so that they would be able to calculate and claim a reduction in the disbursement quota in a subsequent taxation year.

5. The need to distinguish between income and capital

It is possible that some fund agreements do not distinguish the earnings on the endowment portfolios between interest, dividends, and realized and unrealized capital gains, but instead considers all of them as current earnings, while the capital refers to the dollar value of the original gift. CRA's response to question 1 in the CRA Document indicated that in such situations, such gifts may not qualify as ten-year gifts. CRA explained that both realized and unrealized capital gains relating to the original property gifted to the charity, or to property substituted for the gift, form part of the gift that is subject to the holding period. Therefore, where the fund agreements allow a charity to expend these capital gains (both realized and unrealized) prior to the end of the ten-year period, the gift may not qualify as a ten-year gift in the first place, unless such expenditures do not exceed the charity's 3.5% disbursement quota.

The continuing focus on distinguishing between what is capital and what is income is interesting in the context of charities and disbursement quota calculations. This distinction is well known to trust lawyers and trustees who need to ascertain the respective rights and entitlements of income beneficiaries on the one hand and capital beneficiaries on the other hand. However, the distinction between income and capital is difficult for charities to understand and is often ignored. New

investment vehicles, such as mutual funds, which provide blended income and capital payments do not lend themselves easily to determining what is income and what is capital and as such, the tracking of the capital gains pool by charities may prove to be challenging for charities.

6. Encroachment and collapsing a ten-year gift

Prior to Bill C-33, CRA took the position that if all or any portion of the capital of a ten-year gift, or property substituted for it, is expended in a year prior to the expiration of the hold period imposed by the donor, then the *entire* ten-year gift *may* be collapsed and therefore subject to the 80% disbursement quota and create a 80% disbursement requirement in the following year. The 2004 federal budget explained that, since an annual disbursement quota is applied to funds held by charities, sometimes a charity may prefer to (or may be compelled to) meet its obligation to satisfy the disbursement quota by realizing capital gains rather than and in addition to disbursing investment income earned from these funds, especially where the return on the investment is weighted heavily in favour of capital gains or in a low-interest environment. However, "if the charity does so, … it must also then meet an 80 per cent disbursement obligation to the extent that the proceeds of disposition are expended by the charity."[8] This difficulty is caused by the fact that the then 4.5% disbursement quota (now reduced to 3.5%) and the 80% disbursement quota applicable to the portion of a ten-year gift expended in any year are *cumulative* disbursement quota obligations. Under the old rules, when an amount that has been subject of a ten-year gift is encroached on to satisfy the 4.5% disbursement quota, it is also bought into the 80% disbursement quota calculation.[9]

The difficulty caused by the wording in the Act was addressed in Bill C-33. In this regard, question 9 in the CRA Document is in relation to situations where a charity encroaches on a ten-year gift, whether the entire ten-year gift would be required to be included in A.1 of the formula for the charity's

[8] See the 2004 federal budget.

[9] For example, consider a gift of $1,000 to a charitable foundation that is subject to a direction that it or property substituted therefor be held for a period of not less than ten years. Assume that due to the poor return on investment in the 12th year (i.e. after the ten year restriction has expired), no income is earned on the gift in a particular year. In order to meet the 4.5% disbursement quota, which would be equal to $45, the foundation would be required to encroach on the capital (because no income is generated in that year in the example). However, since the 4.5% disbursement quota and the 80% disbursement quota are cumulative disbursement obligations, the foundation would be required to disburse 80% of the amount of the capital encroached upon to satisfy the 80% disbursement quota, leaving only 20% of the amount encroached upon to satisfy the $45 disbursement obligation associated with the 4.5% disbursement quota. Consequently, although only $45 of capital is required to satisfy the 4.5% disbursement quota, the foundation would be required to encroach upon a total of $225 of capital (so that 80% of the $225, i.e. $180, would be used to satisfy the 80% disbursement quota and 20% of the $225, i.e., $45, would be used to satisfy the 4.5% disbursement quota).

disbursement quota for the year, or only the portion of the gift that was expended in the year that must be included in the calculation. CRA indicated that if the terms of the fund agreements permit the charity to expend a portion of the property gifted in excess of its 3.5% disbursement quota, the gift would not qualify as enduring property in the first place and 80% of the gift would be required to be included the charity's 80% disbursement quota and create an 80% disbursement requirement in the taxation year subsequent to the year in which the gift was made. However, where a portion of an enduring property is expended, only 80% of the amount spent and 100% of amount transferred to qualified donees would be required to be reflected in A.1 of the formula for the charity's disbursement quota in the taxation year that the amount was expended or transferred. Similarly, the remainder of the gift would not be included in the charity's A.1 in the formula for the charity's disbursement quota until is expended or transferred to a qualified donee.

7. Filing T3010

Lastly, CRA's response to question 8 in the CRA Document addressed the issue of whether a charity should apply for relief or just continue filing the T3010 if it is unable to meet its disbursement quota in 2009 because of the financial crisis. CRA's response reminded that a charity has the obligation to file its T3010 annual information return and it may lose its charitable registration if the form is not filed on time. However, CRA also reminded that a charity may apply for relief under subsection 149.1(5) of the Act if it is unable to meet its disbursement quota due to unforeseen circumstances that are beyond its control.[10]

[10] For more information, see CRA's *Policy Commentary* CPC-029, "Application for disbursement quota relief", available on CRA's website at http://www.cra-arc.gc.ca/tx/chrts/plcy/cpc/cpc-029-eng.html.

F. CONCLUSION

Although the concept of enduring property, capital gains pool, and encroachment of ten-year gifts have been in operation since its introduction in 2005, there are still many questions regarding how the terms apply in practice. This underscores the complexities of the disbursement quota formula that was introduced in 2005. In spite of CRA's attempts to clarify the application of these rules, it is the author's concern that many charities may still be left in an uncertain and vulnerable position.

CARTERS.ca

Carters Professional Corporation / Société professionnelle Carters
Barristers, Solicitors & Trade-mark Agents / Avocats et agents de marques de commerce

Ottawa (613) 235-4774
Mississauga (905) 306-2791
Orangeville (519) 942-0001
Toll Free: 1-877-942-0001
www.charitylaw.ca