

**ENDOWED AND RESTRICTED GIFTS:
WHAT THE GIFT PLANNER NEEDS TO KNOW**

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INTRODUCTION

Many gifts to charities, particularly larger gifts, are subject to restrictions on how or when the gifted property can be used. If a charity accepts a gift that is subject to such restrictions, the charity is legally bound by the restrictions. The restricted gift, in fact, creates a charitable purpose trust and the charity, as trustee, is subject to the legal regime governing such trusts.

Many charities in Canada do not fully appreciate the legal implications of accepting restricted gifts. Failing to honour such restrictions may expose the charity, and its directors or trustees to liability for breach of trust claims. It also has the potential to erode donor confidence and undermine the credibility of the recipient charity and of the sector generally.

The legal obligations that ensue from accepting a restricted gift can be onerous. It is important that the implications of the restrictions be fully appreciated before the gifts are accepted. Often there are opportunities to make suggestions to the donor regarding the proposed restrictions that will make the gift much easier for the charity to administer without undermining the donor's objective. That extra effort at the outset will make it easier and more efficient for the charity to comply with the restrictions imposed by the donor. It can also avoid expensive legal proceedings and donor dissatisfaction that can arise if a restricted gift is accepted and then the recipient charity discovers that it is impractical or impossible to comply with the restrictions.

THE LEGAL NATURE OF A CHARITABLE PURPOSE TRUST

An unrestricted charitable gift is one that is not subject to any restrictions imposed either directly or indirectly by the donor, other than the legal requirement that the gift be used for the charitable purpose of the recipient charity. As a result, the recipient charity is at liberty to apply an unrestricted gift to its charitable purposes as described in its constating documents without limitations.

This means that, provided the charity does not act *ultra vires* of its charitable purposes, the charity may use the gift in its absolute discretion. This may involve disbursing all or a portion of the gift, or investing the gift either over the short term or in perpetuity and using the income to pursue any one of the authorized charitable purposes within the constating documents of the charity. In addition, if the board of a charity decides to earmark unrestricted charitable gifts for a specific charitable purpose, there is nothing to stop the board from subsequently changing its mind and applying the funds to another charitable purpose within the charity's objects.

While unrestricted charitable gifts are beneficially owned by a charity for its general charitable purposes, restricted gifts are held by the charity in trust for the purposes specified by the donor and are not owned beneficially by the charity. The charity is, in fact, holding the gifted property subject to a separate purpose trust within the confines of its own general charitable purpose (a charity within a charity). Although for trust law purposes each charitable purpose trust is a separate trust, as long as the trustee is a registered charity, Canada Custom and Revenue Agency ignores the existence of the separate charitable purpose trusts for purposes of the *Income Tax Act*.

The fundamental obligation of a trustee is to hold the trust property for the benefit of the trust objects in accordance with the specific terms of the trust. When the trust objects are identifiable persons, those person are entitled to compel the trustee to act in their best interests in accordance with the terms of the trust. When the objects of a trust are purposes rather than persons, there is no interested party who can compel proper administration of the trust. For that reason, the general law is that trusts for purposes are not valid. An exemption has been made for charitable purpose trusts on the basis that the Crown, as *parens patrie* for charities, has the power to enforce the performance of the trust. In Canada, the Crown's perogative is exercised by the Attorney General or the Public Guardian and Trustee for each Province. It may be that the Attorney General or the Public Guardian and Trustee is less inclined to diligently monitor the performance of charitable purpose trusts than an individual who is personally interested in a private trust. The fact that enforcement of charitable purpose trusts may be less vigorous than private trusts does not, however, change the nature of the trustees' legal obligations or the potential liability for a breach of trust. An overview of how to avoid liability arising from restricted gifts is attached hereto as Appendix A.

The trustees of a charitable purpose trust, like the trustees of any other trust, are also subject to general trust law principles governing the administration of the trust. Thus, for example, the assets held pursuant to a charitable purpose trust must be segregated from the other assets held by the trustees unless the terms of the trust expressly permits co-mingling.

Furthermore, the trustees must invest the trust property in accordance with the applicable standard. In most provinces, that standard is the "prudent person" rule which requires the trustees to invest in the manner in which a reasonably prudent person would invest. That standard can be modified by the terms of the trust, but if it is not, the trustees may be obligated to convert the gifted property and invest the proceeds in a prudent manner even if the donor does not favour conversion.

The trustee also has a duty to account for the administration of the trust. This means that the trustees must at all time be ready to provide "full explanations of all of their dealings, and of the cause why outstanding assets were not collected, or property of the estate has disappeared."¹ Although only the Attorney General or Public Guardian and Trustee can compel the trustee to provide an accounting, it is a practical necessity that charities be willing and able to properly account to donors for the administration of charitable purpose trusts.

PRECATORY WISHES AND DONOR ADVISED FUNDS

The basic characteristic of precatory wishes or donor advised funds, in contrast to restricted charitable gifts, is that they do not impose any legally enforceable obligation upon the recipient charity. They are simply an expression of the donor's preference. Notwithstanding the absence of a legal obligation, there are practical consequences to accepting gifts that are subject to precatory wishes or donor advice.

¹ *Chrisholm v. Bernard* (1864), 10 Gr. 479 at 481

Precatory wishes are typically conveyed at the time the gift is made. Often such wishes are described as “precatory trusts”, however, they are not really trusts at all as evidenced by the following quotation from Justice Blain in the *Christian Brothers* case:

A "precatory trust" is not a trust at all. Where the donor gives or bequeaths the property to the charitable corporation absolutely and merely imposes some sort of a moral obligation on the corporation to use the property in a certain way -- using words of expectation or desire or purpose, but not words indicating that the donee is not to take the property beneficially but only for the objects or purposes described -- no charitable purpose trust is established. The charitable corporation takes the gift or bequest and holds it -- and any property derived from it -- for the general charitable purposes and objects of the corporation.²

Distinguishing precatory wishes from binding trust obligations can be difficult. Clearly the use of phrases such as “in trust” or “on condition that” or other mandatory language suggest the creation of a legally binding restriction. On the other hand, words such as “wish” or “desire” suggest that the donor did not intend to create a legal obligation. The difficulty arises when donors use less clear or contradictory terminology. In such circumstances, it may be necessary to obtain a legal opinion in order to determine whether a trust has been created.

A donor advised fund arises when the donor makes a gift to a charity and then periodically makes non-binding recommendations on the distribution of assets from the fund to other charities or for certain charitable activities. Donor advised funds are widely used both in Canada and in the United States by community trusts or foundations. In a sense, donor advised funds create more challenges for the charity than gifts subject to an initial precatory wish, because the charity has a moral obligation (though not a legal duty) to respond to the wishes of the donor on an on-going basis.

In many respects, a gift that is accompanied by precatory wishes or ongoing advice is more desirable to the recipient charity than one that is subject to legally binding restrictions. Most significantly, the charity will have the flexibility to change the use of the gifted property without legal impediments if the original intention becomes impractical or impossible to carry out. Furthermore, the administration of the gifted property will not be subject to the legal constraints that govern restricted gifts (such as the prohibition on co-mingling of assets and the requirement to account separately for restricted gifts) and that may reduce costs and complexity. Donors may also prefer gifts that are subject only to non-binding wishes or advice, because the charity will have greater flexibility to respond to changes in the donor’s objectives.

In other respects, however, gifts that are subject only to non-binding wishes or advice can be problematical for charities. That is because the directors or trustees of the recipient charity have a duty to act in the best interests of the charity. It may be that from time to time the advice or wishes of the donors are at odds with the best interests of the charity. In such circumstances, the directors or trustees must comply with their legal obligations notwithstanding that doing so may

² *Christian Brothers of Ireland in Canada (Re)* (1998), 37 O.R. (3ed) 396

impair the relationship with the donor. If, on the other hand, the donors intentions were imposed upon the charity in the form of a legally binding restriction, then the directors of trustees would be compelled to comply with the donor's intentions. It should also be noted that although there is no legal requirement to account separately for unrestricted gifts, if the charity intends to report to the donor and demonstrate compliance with non-binding wishes or advice, it will be necessary to account separately for the gifted property. Thus, the reduced cost and complexity generally thought to ensue from unrestricted gifts may be illusory when the gifts are subject to non-binding wishes or advice.

RESTRICTIONS ON USE

Donors will often have a desire for certainty that their gift will be used only in a certain prescribed manner. That sentiment is reflected in the following passage from Law of Trusts in Canada by D.W.M. Waters:

The absolute gift suffers as a medium for giving in that, once he has departed with his property, the donor has no control over it in the hands of the donee. Whether or not the donee honours what he knows to be the motives or intentions of the donor in making the gift is, and always has been, a matter solely for the conscience of the donee³.

In order to satisfy the donor's desire for certainty, he or she may impose legally binding restrictions on how gifted property is to be used. For the charity, such restriction on how gifted property can be used raise a number of issues that must be carefully considered before the charity accepts the gift.

The first issue that must be considered is whether the restricted gift is exclusively charitable. If the restriction requires that the gifted property can be used in a manner that is not exclusively charitable, then the trust is valid and the gift fails. Determining whether or not particular restrictions on use of gifted property are exclusively charitable is not always easy. There is no precise legal definition of charity. Instead the law recognizes the following four general heads of charity:

1. the relief of poverty;
2. the advancement of education;
3. the advancement of religion; and
4. other purposes beneficial to the community.⁴

In addition to falling within one of the four heads of charity, the particular use of gifted property must be for the public benefit, meaning that it must benefit the public at large or a significantly large section of the public. Over the years there have been many cases which have considered

³ D.W.M. Waters, Law of Trusts in Canada, 2nd ed. (Toronto: Carswell, 1984), p.501

⁴ Income Tax Commrs. V. Pense, [1891] A.C. 531 (H.L.)

whether a particular purpose falls within one of the four heads of charity and whether it is for the public benefit. The results of those cases often turn on subtle distinctions in the wording of the restriction. One example that illustrates the significance of subtle distinctions in wording is the Diplock litigation⁵ in which the court determined that while a trust for “charitable and benevolent” purposes is charitable, a trust for “charitable or benevolent” purposes is not. It is important, therefore, that charities and donors obtain proper legal advice on the wording of the restrictions. If the charity does not have an opportunity to provide input into the drafting of the restriction, it should ask legal counsel to confirm that the gift is exclusively charitable prior to accepting the gift.

Even if the gift is exclusively charitable at law, the charity must not accept a restriction on the use of gifted property that is not within the objects of the charity. The objects of the charity, as described in the constating documents, are the sole purposes that the charity is legally authorized to pursue. If the charity accepts a restricted gift that requires the charity to use the gifted property in a manner that is not contemplated by the charity’s objects, the directors or trustees of the charity will be personally liable for the actions of the charity.

Another consideration that arises with respect to restrictions on the use of gifted property is whether the restriction is void because it is contrary to public policy. The general law is that any restrictions that are discriminatory will be void unless they discriminate in favour of historically disadvantaged groups (eg. women, disabled people, people of colour)⁶. The courts have, however, found that certain types of restrictions that prefer one class of persons are not void. For example, in *the Estate of F.G McConnell*⁷, the British Columbia Supreme Court was asked to consider whether the restrictions attached to a testamentary gift to the University of Victoria were void because they discriminate in favour of a certain group. In that case, the restriction was that the gifted property was to be used to provide bursaries to Catholic students. The Court held that, in that case, the discriminatory language was “relatively innocuous” and was not offensive to the degree necessary to warrant undermining the testator’s right to testamentary freedom.

Even if there are no legal impediments to accepting a restricted gift, there may be practical reasons why the charity may want to decline the gift. A charity may not have the capacity to comply with restrictions that are incompatible with its mission. Alternatively, the administrative requirements of a restricted gift may consume an inordinate amount of the charity’s resources. In such circumstances, the charity would best serve its charitable objects by declining the gift. In order to ensure that such inappropriate or onerous restrictions are not accepted without due consideration of both the legal and practical implications, it is prudent for charities to adopt a policy that all restricted gifts must be approved by senior management or by the directors or trustees. Charities should also avoid simplistic targets or quotas that encourage development staff to accept restricted gifts that are not in the best interests of the recipient charities.

⁵ Ministry of Health v. Simpson, [1951] A.C. 251 (see Waters at p.603)

⁶ See for example, Leonard Foundation Trust (1897) 27 E.T.R. 193

⁷ 2000 B.C.S.C. 445

RESTRICTIONS ON TIMING

Charitable purpose trusts enjoy special treatment in that unlike private trusts, they are not subject to the rule against perpetuities. Thus, donors may make gifts subject to the restriction that capital be retained perpetually. In contrast, the income of a charitable purpose trust is subject to the ordinary rules that preclude accumulations for longer than 21 years. The impact of these trust law rules must, however, be considered in light of the disbursement quota rules imposed upon charities by the *Income Tax Act*.

If the donor proposes to make a gift subject to restrictions on when the gifted property can be used, the recipient charity must consider carefully the impact that the restricted gift will have on its disbursement quota. Although a charity's disbursement quota is calculated on all of its assets (including assets held in trust by the charity), accepting a large restricted gift or a number of smaller restricted gifts could make it impossible for the charity to meet its quota obligations. It is essential that charities have a thorough understanding of the disbursement quota rules and the impact that restricted gifts can have on the charity's ability to meet its quota. A complete overview of the disbursement quota rules and some of the problems that can arise with respect to the disbursement quota is attached hereto as Appendix B.

The standard disbursement quota rule is the 80% rule. This rule requires charities to disburse each year an amount equal to 80% of receipted gifts for the previous year, by making grants to other charities or in carrying on charitable activities directly. The 80% rule does not apply to gifts from other registered charities, gifts by way of bequest or inheritance or gifts that are subject to a "ten-year direction".

As a result of the 80% rule, it is very difficult for charities to accept gifts that are subject to a restriction that prohibits use of the gifted property for a period of time, unless the gift falls within one of the exemptions described above. For example, a gift of cash from a living donor that is subject to a restriction that the cash and the income derived therefrom not be disbursed for at least three years, would be problematic. In the year after the gift is received, the charity's disbursement quota would be increased by 80% of the value of the gift, but the charity will not be able to distribute the gifted property in order to meet its quota. The charity's other resources would, therefore, have to be sufficient to permit it to meet its quota.

Some relief from the 80% rule is available pursuant to ss.149.1(8) of the *Income Tax Act*. That provision allows a charity to apply to the Minister of Revenue to permit it to accumulate property for a particular purpose. If the Minister grants permission to accumulate the property, then such property and the income therefrom will be deemed to have been expended on charitable activities in the year. It is important to note that relief pursuant to ss.149.1(8) is only available if the application is made and granted prior to the accumulation. It is not intended to provide remedial relief when the problem has already occurred.

If a donor wishes to make a gift (other than by way of bequest or inheritance) that restricts use of the property for a period of time, then the most common way to avoid the dilemma of the 80% rule is to make the gift subject to a "ten-year direction". Such gifts are described in ss.149.1 of the *Income Tax Act* as follows:

A gift received subject to a trust or direction to the effect that the property given, or property substituted therefore, is to be held by the foundation for a period of not less than 10 years.

Gifts that are subject to a ten-year direction are not subject to the 80% rule disbursement quota rule. The charity will, however, still be subject to the other basic disbursement quota rule referred to as the “4.5% rule”. The 4.5% rule requires that each year a charity must disburse an amount that is not less than 4.5% of the average value of the charity’s assets over the preceding 24 months. The 4.5% rule, like the 80% rule, is calculated on the charity’s assets as a whole and not on specific purpose trusts. If, however, the charity has significant funds that cannot be distributed because of donor imposed restrictions, it may have difficulty meeting the 4.5% disbursement quota obligation.

It is important to note that the effect of a ten-year direction is to prohibit distribution of capital for at least 10 years. Capital, in the trust law context, includes capital gains. Thus, a charity that holds nothing but 10 gifts must invest in a manner such that the interest, dividends or rent (but not capital gains) are sufficient to permit it to meet its 4.5% disbursement quota obligation.

For the past several years, due to the low interest rate environment, it has not been easy for many charities that hold significant 10 year gifts to meet the 4.5% rule. In an attempt to address this issue, Canada Customs & Revenue Agency has suggested that if the donor releases the direction that capital be held for not less than 10 years, then entire gifts will be deemed to be received in the year and will then be subject to the 80% rule. The problem is that, at law, neither the donor nor the charity have the power to change the terms of the trust. There is, therefore, no legal means of releasing the direction other than through a court order.

VARIATION OF RESTRICTIONS

Notwithstanding well-established law to the contrary, many donors and many charities believe that the terms of a restricted gift can be easily varied. In fact, only the courts can vary the terms of a charitable purpose trust based upon the court’s inherent scheme-making power. As stated in *Tudor* on charities:

*It is not for the directors or trustees of a charity to deal with the funds on their own authority, even with the direction or approval of the original donor.*⁸

This means that to vary a donor restricted charitable gift, an application must be made for a *cy-près* order. *Cy-près* is a shortened form of the phrase “*cy-près comme possible*,” which in Norman French means “as near as possible.”

The *cy-près* doctrine is generally stated as follows:

⁸ Tudor on Charities 8th ed. (1995) p.245

If property is given in trust to be applied to a particular charitable purpose, and it is or becomes impossible or impracticable or illegal to carry out the particular purpose, and if the settlor manifested a more general intention to devote the property to charitable purposes, the trust will not fail but the court will direct the application of the property to some charitable purpose which falls within the general charitable intention of the settlor.⁹

Whether the court will be able to exercise a *cy-près* scheme will depend upon whether the failure is an initial failure or a subsequent failure. With an initial failure, the court will be able to intervene and apply the charitable property *cy-près* only if it can find a general charitable intention of the donor. This becomes particularly problematical in relation to public fund-raising campaigns. If a surplus results from a public fund-raising campaign for a particular charitable purpose and the charity is unable to use the monies for its publicly stated purpose, the court will be able to apply the remaining surplus to another charitable purpose only if it can find that the donors, many of whom may be anonymous, had a general charitable intention and did not limit their gifts to the specific project for which the fund-raising campaign was directed. The primary problem involved with the public surpluses resulting from public fundraising campaigns is therefore determining whether or not a general charitable intent can be found.

To avoid the complexities and costs of making a *cy-près* court application and the possibility that the court may not find a general charitable intention in relation to a surplus for a public fund-raising campaign, a charity should clearly state that any surpluses resulting from a public fund-raising campaign for a particular project will be used to further the general charitable purposes of the charity in question.

In the event of a subsequent failure of a special purpose charitable trust, the court will apply the *cy-près* doctrine where it can be shown that there is a supervening impracticality or impossibility, without finding a general charitable intent. This is, of course, subject to the requirement that the gift not contain a provision for a gift over by the donor.

In addition to the power to vary the objects of a charitable purpose trust, the court may also exercise a scheme-making power where adherence to the administrative terms of a trust would disrupt the specific purpose of the charitable trust. The normal situation where the court will permit deviation from administrative terms is where a change in circumstances makes adherence to the original administrative terms impossible or impractical. A recent application of the administrative scheme-making power of the court involved the Barnes Foundation in Pennsylvania where the donor, Dr. Albert Barnes, included in the declaration of trust creating the foundation provisions which severely limited the investment policy of the foundation's endowment funds and strictly forbade charging entrance fees to his impressionist painting collection, the construction of new buildings for the collection and the sale or loan of any of the paintings under any circumstances short of physical deterioration. Due to the inability of the trustees to administer effectively and protect the paintings, the court allowed a variation of the administrative terms of trust to permit the collection of entrance fees and the loaning of pictures

⁹ American Law Institute, Restatement (Second) of Trusts (Washington, D.C.: 1959) at para 399

to other museums, so that sufficient money could be earned to properly care for and maintain the collection.

DOCUMENTING RESTRICTED GIFTS

When a gift to a charity is made subject to restrictions, the terms of the gift must be properly documented. Charities that receive many restricted gifts should develop standard documentation. To the extent that documents can be standardized, it will facilitate initial review and on-going administration of the gift.

The documentation need not be lengthy or complex. Typically, a properly drafted deed or letter of one or two pages in length will suffice. The document should specify the name of the trust, if it is to be named, and should carefully describe the objects of the trust. A standard gift over clause should be included in the event that the primary objects become impossible or impractical to carry out. The document should also incorporate by reference administrative powers (such as the power to co-mingle trust property with other assets held by the charity) contained in the charity's constating documents in order to provide the charity with the flexibility to administer the trust in a practical and efficient manner.

The document establishing the terms of the gift must be signed by the donor. It should also expressly state that the gift does not become effective until the property is transferred to the charity and the document is signed by the authorized signatories of the charity. The authorized signatories of the charity should not sign the document until they are satisfied that there are no legal or practical impediments to accepting the restricted gift.

Once the documentation has been signed, a system must be developed to ensure appropriate record keeping and on-going administration of the trust in accordance with its terms.

CONCLUSION

Donors like restricted gifts because such gifts provide greater certainty that the donors' specific philanthropic objectives will be advanced. For the recipient charities, gifts that are subject to restrictions create legal and administrative burdens that can be quite onerous. In certain instances, those burdens will be too onerous and the charity should decline the gift. Most charities, however, will accept some restricted gifts because they are a too important a source of funds to reject categorically. The decision to accept the benefit of restricted gifts carries with it the responsibility to deal with those gifts properly. Charities that fail to discharge that responsibility risk exposure to liability and loss of donor confidence. Charities that develop and maintain the capacity to handle restricted gifts properly will earn the respect and confidence of donors and enhance the representation of the charitable sector as a whole.

APPENDIX A:

**AVOIDING LIABILITY INVOLVING DONOR RESTRICTED
CHARITABLE GIFTS**

Excerpt from “*Looking a Gift Horse in the Mouth*”: *Avoiding Liability in Charitable Fundraising*, ©2001, Terrance S. Carter, B.A., LL.B., available at www.charitylaw.ca.

AVOIDING LIABILITY INVOLVING DONOR RESTRICTED CHARITABLE GIFTS

The case law concerning breach of trust involving donor restricted charitable gifts has been well established in England, as well as in Canada. Some examples of fact situations where the courts have found that there has been breach of trust involving donor restricted charitable gifts are summarized below as follow:

- A charity diverting a fund intended for one charitable program for use in another charitable program. For example, a charity using monies from an estate that was intended by the testator to help the poor in one parish by diverting those monies to help the poor in another parish.
- A charity withholding a fund and not having it applied to the purpose for which it was intended by the donor.
- The trustees of a charity concealing the existence of a charitable trust fund by not communicating its existence to the persons or groups intended to benefit from it.
- A charity placing funds into a perpetual endowment fund when all of the funds were intended by the donor to be expended in the short term in support of a particular operational program of the charity.
- A charity mixing its funds with another charity and then applying the combined funds for the purposes of the other charity.
- A charity encroaching upon the capital of an endowment fund that was intended by the donor to be held in perpetuity.
- A church that had received land in trust to further a particular doctrinal statement subsequently using the land for the benefit of individuals adhering to a different doctrinal statement.
- The members of a church unilaterally attempting to alter the terms of a trust deed for church property without first obtaining court authorization.
- A charity borrowing monies from a donor restricted charitable trust fund notwithstanding that there was a bona fide intent to repay those monies together with interest.
- A charity using surplus funds from a public fundraising appeal for different charitable purposes from that communicated in the public appeal without first obtaining court authorization.

- The directors of a charity altering the terms of a donor's restriction without first obtaining court authorization.

A. Can a Donor Restriction be Unilaterally Varied?

Notwithstanding well-established law to the contrary, the boards of many charities believe that a charity somehow has an inherent right to unilaterally vary the terms of a donor restriction or to liberally interpret what the applicable restriction means. Alternatively, many charities that receive a testamentary gift which is subject to restrictions believe that the executor of the estate also has an inherent ability to unilaterally vary or liberally interpret the donor's restrictions. Neither of these assumptions, though, is correct. Only the courts can vary the terms of a restricted special purpose charitable trust based on the court's inherent scheme-making power.

This means that to vary a donor restricted charitable gift, an application must be made for a cy-près order. Any attempt to unilaterally vary a donor restricted charitable gift based upon the consent of only the donor, with the charity acting on its own, without first obtaining the necessary court approval, would likely constitute a breach of trust and must therefore be carefully avoided notwithstanding the time and expense of making the necessary court application.

There are two situations, however, in which court approval to vary a donor restricted charitable gift may not be necessary. The first situation is where a cy-près court application is not successful and the gift reverts back to the donor in circumstances where there is no gift over to another charity. The second situation results in the same effect, but is due to the failure of either a condition precedent or a condition subsequent where there is a reversion back to the donor. In both situations, the donor would be able to unilaterally re-issue the gift to the intended charity once the donor had received the gift back and at that point establish either new restrictions or re-issue the gift without any restrictions being imposed.

B. How Should Donor Restricted Gifts be Managed once Received?

Often, a charity will run into difficulties in dealing with donor restricted charitable gifts due to either a lack of understanding of the legal consequences involved with such gifts or a failure by the charity to implement appropriate policies to effectively manage donor restricted charitable gifts once received. In this regard, the following is provided as a brief summary of some of the practical considerations that should be considered by a charity and its board of directors, management and fundraisers in effectively managing donor restricted charitable gifts that are received:

(1) Identifying the Nature of the Charitable Gift

Since the legal consequences associated with donor restricted charitable gifts are very serious, it is important for a charity to retain the assistance of legal counsel in drafting guidelines to help the charity to identify the legal distinctions of gifts received. In this regard, the guidelines should provide examples of gifts that are subject to terms, restrictions, or conditions that will need to be scrutinized to determine whether or not they may constitute donor restricted charitable trusts, as well as providing examples of gifts that are clearly unrestricted.

If the charity were unsure of or had any questions concerning the nature of the gift, then the instrument creating the gift should be forwarded to legal counsel for the charity so that an appropriate legal opinion could be obtained. Once a gift has been identified as a donor restricted charitable gift, it needs to be properly labelled as such and subsequently treated as a special purpose charitable trust.

(2) Reviewing and Approving Donor Restrictions

Whenever a gift is received that is identified as a donor restricted charitable gift, it is important that the management of the charity carefully review the terms of the donor restrictions to ensure that the following questions are addressed:

- Are the restrictions charitable?
- If so, are the restrictions within the charitable purposes of the charity?
- Are the restrictions both possible and practicable?
- If they are, then are the restrictions acceptable to the charity?
- If any of the above questions are answered in the negative, then the charity should not accept the gift. Instead, the gift should be returned to the donor and no charitable tax receipt should be issued.
- Alternatively, if the gift is subject to restrictions that the charity wishes to accept but such restrictions are either impossible or impractical, then the charity would need to apply to a court to have the court exercise its cy-près scheme making power to vary the terms of the donor restricted charitable trust “as near as possible” to the original restrictions imposed by the donor.

(3) Effective Ongoing Management of Donor Restricted Charitable Gifts

Once a decision is made to accept a donor restricted charitable gift, then the charity and its management must be careful to ensure that the funds in question are properly managed as charitable trust funds on an ongoing basis. Appropriate management in this regard would involve looking at the following considerations:

- Since a donor restricted charitable gift is by its very nature given to a specific charity or trustee, the gift must be deposited into the bank account of that charity and used by that charity for the stated charitable purposes, unless the objects and power clauses of the named charity permit the funds to be subsequently transferred to another charity.
- Donor restricted charitable funds must be invested in accordance with the specific investment powers set out in the document creating the restricted charitable trust or, if there is no special investment clause, in accordance with the general investment powers of the charity.

- The charity must never borrow against donor restricted charitable funds, whether to further other charitable purposes of the charity or to underwrite the general operations of the charity, notwithstanding that the board may intend to repay the monies at a later time with interest.
- At common law, each donor restricted trust fund is required to be held separately from other restricted trust funds and cannot be co-mingled together. Very few charities, though, comply with this common law prohibition against co-mingling. As such, recent regulations under s.5.1 of the Ontario Charities Accounting Act have permitted co-mingling of restricted funds by a charity.
- Since donor restricted charitable gifts are often testamentary gifts, it is important for the charity to maintain ongoing communication with family members of the testator to provide information and confirmation of compliance by the charity with the applicable restrictions. Good communication in this regard can help to avoid misunderstandings in the future between family members of the testator and the charity that might otherwise lead to legal action.
- A transfer of a donor restricted charitable trust from one charity to another will require at the very least a written appointment in accordance with s.3 of the Trustee Act to document a change in trustees. A transfer may also require court authorization pursuant to a consent order obtained under s.13.(1) of the Ontario Charities Accounting Act in the event that the nature of the donor restriction contemplated that the role of the named charity as the trustee of the fund was a fundamental term of the donor restricted charitable trust.
- The proceeds realized from the sale of charitable property that is subject to a special purpose charitable trust, such as a trust deed for church property, will remain impressed with the terms of that trust and may have to be accounted for as a special purpose charitable trust fund on a perpetual basis, unless court approval is first received to vary the terms in accordance with a cy-près application.

C. How Can Donor Restricted Charitable Gifts be Avoided in the First Instance?

Since donor restricted charitable gifts involve considerable legal responsibility and exposure to liability, an important question that a charity should ask is what can be done on a practical basis to encourage donors to give unrestricted gifts instead of restricted charitable gifts. This is not to suggest that there is not a place for donor restricted gifts. However, a program of good legal risk management in avoiding breach of trust should involve taking pro-active steps to avoid situations that might otherwise give rise to a breach of trust before it occurs instead of trying to remedy the problem after the fact.

Some practical suggestions in this regard are outlined below as follows:

- The simplest approach is to encourage donors to give unrestricted gifts as much as possible. This could be done by providing sample bequest clauses that make reference to the general purposes of the charity without suggesting the option of giving a

restricted gift. For instance, a sample bequest clause could read “to ABC charity for its general charitable purposes.”

- If a donor wanted to give directions concerning how a gift was to be used, then the donor could be encouraged to use wording that constitutes “suggestions” only as opposed to a binding restrictions. For instance “to ABC charity, with the request, but not the legal obligation, that the gift be used for _____.”
- Fundraisers should be instructed in understanding and identifying the differences between unrestricted charitable gifts and donor restricted charitable gifts, so that they can encourage donors to focus on the flexibility of an unrestricted charitable gift for the charity over that of a restricted gift.
- As a precautionary measure, fundraising materials should include a statement to explain that all gifts will be considered to have been given to further the general charitable purposes of the charity in accordance with its needs from time to time, unless the donor has specifically stated that the gift is to be subject to binding restrictions, in which event the donor would be encouraged to contact the charity to discuss the specific terms of the restriction before making such a gift.

D. Preventative Steps to Reduce Liability Involving Donor Restricted Charitable Gifts

Since it is not realistic to expect that all gifts that a charity will receive will be of an unrestricted nature, it is important for a charity to also take pro-active steps to develop and implement a policy to reduce the risks associated with receiving donor restricted charitable gifts, in recognition that such gifts are likely to be given at some time in the future.

Public fundraising appeals for a specific program, such as monies required for a building program, should contain a clear statement that any surplus monies remaining after the necessary funds have been raised for the designated project or program will be used to further the general charitable purposes of the charity. This would avoid the charity having to make a *cy-près* court application to obtain judicial direction on what to do with the surplus remaining from a public fundraising campaign.

Suggested wording given to a prospective donor and the donor’s solicitor concerning an estate legacy where a donor wants to include a restricted charitable gift should include a standard *cy-près* clause in the will so that the charity will be able to unilaterally modify the restrictions imposed by the donor in the event that such restrictions become impossible or impracticable in the future.

To avoid a donor restricted charitable gift subsequently failing and the gift reverting back to either the donor or to the beneficiaries of the testator, it is important that the wording used in the document creating the restricted gift, such as the will, use clear language to identify the specific charitable purpose for which the monies are to be used and who the beneficiary is to be; otherwise, the gift may fail altogether for lack of certainty. In this regard, and in accordance with *Christian Brothers* case, it would be prudent to include language that clearly evidences that a charitable trust has been created, such as using the phrase “in trust,” and to ensure that the

formalities of the three certainties of a trust are met (ie, who is the trustee, what is the trust property, and what is the charitable purpose?).

In the event that the donor intends to give endowment funds where the capital is to be held in perpetuity and the interest income is to be used for operational purposes of the charity, then the donor should be encouraged to place only general restrictions on how the income can be used; but, in any event, the donor should include a cy-près clause referred to above in order to unilaterally vary the terms of the restriction. The inclusion of such a clause would ensure that the charity would have the ability to redirect the income earned from the endowment fund in the event that the restrictions concerning how the income is to be used became impossible or impracticable.è

APPENDIX B:

SUMMARY OF DISBURSEMENT QUOTA RULES

DISBURSEMENT QUOTA REQUIREMENTS

What is the disbursement quota?

The disbursement quota is a prescribed amount (the quota) that registered charities are required under the *Income Tax Act* (Canada) (the “*Act*”) to disburse each year in order to maintain their charitable registration. In particular, it is a prescribed amount that must be spent each year in a charitable capacity. The purpose of the disbursement quota is to ensure that charities use the bulk of their tax receipted gifts on charitable activities/purposes. It is intended to discourage charities from spending excessive amounts on fund raising and from accumulating excessive funds. There are different disbursement quotas for the three categories of registered charities, namely, charitable organizations, public foundations and private foundations.

What is the disbursement quota for charitable organizations?

A charitable organization is required to disburse the following per year:¹

1. 80 per cent of all amounts for which it issued official donation receipts in its *preceding* taxation year excluding donation receipts issued for the following:
 - (a) gifts of capital received under a will (“bequests”);
 - (b) gifts subject to a trust or direction that the gift, or property substituted for it, be held for at least 10 years; and
 - (c) gifts received from other registered charities.²
2. 80 per cent of the following amounts that were excluded from the disbursement quota in a previous year but were spent in this fiscal period:³ (i) gifts of capital received under a will *after* 1993⁴ and (ii) gifts subject to a trust or direction that the gift, or property substituted for it, be held for at least 10 years.

¹ The definition of “disbursement quota” provided in subsection 149.1(1) of the *Act* is applicable only to charitable foundations. Paragraph 149.1(2)(b) of the *Act* renders this definition applicable to charitable organizations in a modified form.

² It should be noted, however, that typically donation receipts will not be issued for gifts made between charities. Whether or not a donation receipt is issued, a gift received by a charitable organization from another registered charity will not be subject to the charitable organization’s disbursement quota.

³ The 80 per cent requirement applies only to the portion of the previously excluded amount that is actually spent by the charity in a subsequent year. As an example, assume that in 1990 a charity issued a receipt for a \$10,000 gift that was subject to the direction that it be held by the charity for ten years. This \$10,000 will not be subject to the 80 percent disbursement quota for 1991. If, however, in 2001, after the expiration of the ten years, the charity spends \$5,000 of the \$10,000 ten year gift, that \$5,000 will be included in the charity’s disbursement quota for 2001. 80 per cent of the \$5,000 will therefore need to have been disbursed directly on charitable activities. (What it means to disburse money directly on charitable activities is discussed in greater detail below.)

⁴ Bequests of capital received prior to 1994 will never be subject to the 80 per cent disbursement quota.

What is the disbursement quota for public foundations?

A public foundation is required to disburse the following per year:⁵

1. 80 per cent of all amounts for which it issued official donation receipts in its *preceding* taxation year excluding donation receipts issued for either of the following:
 - (a) gifts of capital received under a will (“bequests”);⁶ and
 - (b) gifts subject to a trust or direction that the gift, or property substituted for it, be held for at least 10 years.
2. 80 per cent of all amounts received by it from other registered charities in the preceding taxation year whether or not an official donation receipt was issued except for “specified gifts”.⁷ (Specified gifts are described below.)
3. 80 per cent of the following amounts that were excluded from the disbursement quota in a previous year but were spent in this fiscal period:⁸ (i) gifts of capital received under a will *after 1993* and (ii) gifts subject to a trust or direction that the gift, or property substituted for it, be held for at least 10 years.
4. 4.5 per cent of the product obtained when the following three amounts are subtracted from the average value of the foundation’s “investment property”:
 - 100 per cent of the amount for which official donation receipts were issued in the preceding year including donation receipts issued for amounts received from other registered charities but not including donation receipts issued for gifts of capital received under a will and gifts subject to a trust or direction that the gift, or property substituted for it, be held for at least 10 years.
 - 100 per cent of the amounts received from other registered charities for which no official donations receipts were issued except for “specified gifts”.

⁵ See definition of “disbursement quota” in s. 149.1(1) of the *Act*.

⁶ In Technical Interpretation 9131785, Canada Customs and Revenue Agency took the position that capital “should not be interpreted broadly to include all sources of funding received by way of bequest or inheritance”. A charity therefore should not simply assume that a charitable gift constitutes a bequest of capital simply because it was made pursuant to the terms of a will. For example, if a charity is designated in a will as the income beneficiary of a trust established under that will, the charity will have received an income interest rather than a bequest of capital.

⁷ There is no reason to issue donation receipts for gifts received from other registered charities. The reason for this is that registered charities are tax exempt and, as a result, do not need an official donation receipt in order to receive favourable tax treatment for their gifts to charities. The exemption of specified gifts from the disbursement quota does not turn on whether a donation receipt was issued.

- 100 per cent of amounts under 1(a) or (b) above that were excluded from the disbursement quota in a previous year but were spent in this fiscal period.

“Investment property” includes any real estate or personal property, or part of such property, that (i) was owned by the foundation at any time in the 24 months preceding the fiscal period covered by the tax return and (ii) was not used directly for charitable programs or administration.

What is the disbursement quota for private foundations?

The disbursement quota for private foundations is identical to that for public foundations with one exception. Whereas public foundations must disburse 80 per cent of all amounts received from other registered charities in the preceding taxation year (except for specified gifts), private foundations must disburse 100 per cent of such amounts.⁹

How is the average value of a charitable foundation’s investment property calculated?

The method for calculating the average value of a charitable foundation’s investment property is set out in Regulations 3700 to 3702 under the *Act*.

Are gifts received by registered charities from other registered charities subject to the disbursement quota?

The answer to this question varies with whether the donee charity is a charitable organization or a foundation. Gifts received by charitable organizations from other registered charities are not subject to the charitable organization’s disbursement quota. However, for public foundations the general rule is that the foundation must disburse at least 80 per cent of all amounts received by it from other registered charities in the preceding taxation year. (As indicated above, private foundations must disburse 100 per cent of such amounts.) These rules apply irrespective of whether the foundation issues official donation receipts for these gifts and, while the matter is not free from doubt, appear to apply irrespective of whether the gifts are 10 year gifts. “Specified gifts” constitute an exception to this general rule. (See below.)

What is a “specified gift”?

Specified gifts are gifts given from one charity to another that are designated as specified gifts in the donor charities’ information return for the year in which the gift is made.¹⁰ Specified

⁸ As indicated above, the 80 per cent requirement applies only to the portion of the previously excluded amount that is actually spent by the charity in a subsequent year.

⁹ See the definition of variable “B” contained in the definition of “disbursement quota” under s. 149.1(1) of the *Act*.

¹⁰ Subsection 149.1(1) of the *Act*.

gifts neither increase the disbursement quota of the donee charity nor count towards satisfaction of the disbursement quota of the donor charity.

Any charity that receives a gift from another registered charity should inquire whether the donor charity is going to designate the gift as a specified gift in its information return for the year. The rationale for this varies with whether the donee is a foundation or a charitable organization.

Foundations should make this inquiry because gifts received by foundations from other registered charities will be exempt from the donee foundation's disbursement quota *only* if the donor charity plans to designate the gift as a specified gift in its information return for the year. This rationale does not apply to charitable organizations because a gift received by a charitable organization from another registered charity will be exempt from the disbursement quota of the donee organization whether or not the gift is designated by the donor charity as a specified gift.

Charitable organizations should nevertheless make this inquiry because specified gifts are not included in the calculation of the income of charitable organizations.¹¹ This is significant because charitable organizations are not allowed to disburse more than 50 per cent of their *income* in any year to qualified donees.¹² Charitable organizations therefore need to know whether gifts from other registered charities are specified gifts in order to determine how much they can disburse to other qualified donees without running afoul of the 50 per cent rule. Since foundations are not bound by the 50 per cent rule, this rationale does not apply to them.

What are the disbursement quota implications of “10 year gifts”?

A 10 year gift is a gift that is made subject by the donor to a trust or direction that the gift, or property substituted for it, be held by the donee charity for a “period of not less than 10 years” (the “Hold Period”).¹³ Canada Customs and Revenue Agency (“CCRA”) requires that 10 year gifts be evidenced by writing that meets the following criteria:¹⁴

- the document must be executed by the donor;
- the document must clearly identify the donee charity, including its official name and registration number;
- the document must indicate the amount of the gift;
- the document must set out the date the gift is made;
- the document must set out the name and address of the donor; and
- the document must set out the serial number of the official receipt issued to the donor for the gift.

In addition, a deed of gift creating a 10 year gift should at the minimum be drafted with a view to the following general considerations:

¹¹ Paragraph 149.1(12)(b) of the *Act*.

¹² Paragraph 149.1(6)(b) of the *Act*.

¹³ See the definition of variable “A” contained in the definition of “disbursement quota” under s. 149.1(1) of the *Act*.

¹⁴ Information Circular 80-10R “Registered Charities: Operating a Registered Charity” at paragraph 37.

- The *Act* stipulates that the minimum Hold Period for a 10 year gift is ten years. There is no maximum Hold Period stipulated in the *Act*. The deed of gift should therefore specify whether the Hold Period is ten years, perpetuity or some other period of time not less than ten years.
- It is not necessary for a 10 year gift to constitute a trust. The *Act* merely provides that the gift must be subject to either a “trust or direction” that the gift, or property substituted for it, be held for a period of not less than ten years.¹⁵ It is therefore not necessary for the deed of gift to satisfy the “three certainties” for a trust in order for there to be a valid 10 year gift.
- The deed of gift should specify what, if any, donor restrictions will apply to the use of the 10 year gift after the expiration of the Hold Period.
- CCRA does not consider capital gains earned on 10 year gifts to constitute “income”. (This bodes critical disbursement quota considerations that are discussed below.) While a donor is free to stipulate in the deed of gift that income includes capital gains, it does not appear as though such a stipulation will trump CCRA’s characterization of capital gains for disbursement quota purposes.

In considering the disbursement quota implications of 10 year gifts, it is critical to bear in mind the following general rules:

Limited Exemption from the 80 Per Cent Disbursement Quota:

A 10 year gift, or property substituted for it, will provide a charity with a limited measure of relief from its disbursement quota obligations. First, the income earned on a 10 year gift, or property substituted for it, is at no time included in the calculation of a charity’s disbursement quota. Second, as indicated above, a 10 year gift, or property substituted for it, is exempt from the rule applicable to all registered charities (including charitable organizations and foundations, both private and public) requiring the disbursement of 80 per cent of the previous year’s receipted donations. This latter exemption, however, is a limited exemption. A 10 year gift is exempt from the 80 per cent disbursement quota only until such time as the gift, or property substituted for it, is expended.¹⁶ The portion of the 10 year gift subject to the 80 per cent disbursement at this time will depend, *inter alia*, upon whether the gift is expended prior to or after the expiration of the Hold Period.

If the 10 year gift, or property substituted for it, is expended *after* the expiration of the Hold Period, then only that portion of the gift expended will at that time be subject to the 80 per cent disbursement quota.¹⁷ If the 10 year gift, or property substituted for it, is expended *prior* to the expiration of the Hold Period, then the entire gift *may* collapse and become subject to the 80

¹⁵ See the definition of variable “A” contained in the definition of “disbursement quota” under s. 149.1(1) of the *Act*.

¹⁶ See the definition of variable “A.1” contained in the definition of “disbursement quota” under s. 149.1(1) of the *Act*.

¹⁷ See footnote 4 above.

per cent disbursement quota.¹⁸ The word “may” is used here to connote that the administrative practices of CCRA are at present unclear on this point. We note, however, that the language used in the *Act* suggests that only that portion of the 10 year gift, or property substituted for it, actually expended will become subject to the 80 per cent disbursement quota.

It is important to note that capital gains earned on 10 year gifts are not considered by CCRA to constitute income earned on such gifts. Instead, CCRA considers capital gains as property substituted for the original gift. The expenditure of capital gains earned on 10 year gifts will therefore result in the disbursement quota consequences described in the preceding paragraph (depending upon whether the capital gain was expended prior to or after the expiration of the Hold Period).

Application of 4.5 Per Cent Disbursement Quota:

As indicated above, charitable foundations (but not charitable organizations) are required to disburse an amount equal to 4.5 per cent of the average value of their “investment property”.¹⁹ A 10 year gift, or property substituted for it, is subject to this 4.5 per cent disbursement requirement. The reason for this is that a 10 year gift, or property substituted for it, constitutes investment property.

The consequence of this is that the 10 year gift must generate at least 4.5 per cent in income per year to ensure that the foundation has sufficient funds available to satisfy the 4.5 per cent disbursement requirement in respect of the gift (unless, of course, the foundation has other monies that could be expended for this purpose). As indicated above, prior to the expiration of the Hold Period, the foundation may not, without collapsing the entire gift, be able to realize capital gains in order to meet this disbursement requirement. Capital gains may, however, be realized in order to meet the 4.5 per cent disbursement requirement after the expiration of the Hold Period without collapsing the entire gift.

10 Year Gift Given to a Foundation By Another Registered Charity:

As indicated above, charitable foundations (but not charitable organizations) have included in the calculation of their disbursement quota gifts received the preceding year from other registered charities. Public foundations are required to disburse 80 per cent of such amounts whereas private foundations are required to disburse 100 per of such amounts. This raises the question of whether 10 year gifts received by charitable foundations from other registered charities are subject to these disbursement requirements just like any other gift received by a foundation from another charity.

¹⁸ Completely apart from disbursement quota considerations, the expenditure of a 10 year gift prior to the expiration of the Hold Period may constitute a breach of trust.

¹⁹ This is not completely accurate, since, as indicated above, certain amounts are subtracted from the average value of the foundation’s investment property before the 4.5 per cent disbursement requirement is calculated.

While the matter is not free from doubt, it does not appear as though a 10 year gift will be exempt from these disbursement requirements if the donee of the gift is a foundation, private or public, and the donor is another registered charity.²⁰ This is not the case for charitable organizations, since, as indicated above, gifts received by a charitable organization from other registered charities are not included in the calculation of its disbursement quota.

In any event, a foundation in receipt of a 10 year gift from another registered charity could bring an application under subsection 149.1(5) to have the gift excluded from the calculation of its disbursement quota. CCRA has indicated during informal discussions that it will in certain circumstances exempt such gifts from the donee foundation's disbursement quota. Where CCRA grants such an exemption, the exemption will be conditional. CCRA may, for example, stipulate that the 10 year gift will not be exempt from the 4.5 per cent disbursement requirement but will nonetheless be exempt from the 80 per cent disbursement quota (which, in the case of private foundations, is 100 per cent) until such time as the gift is actually expended. The particular conditions attached by CCRA will depend upon the circumstances in question.

Transferring A 10 Year Gift From One Charity to Another Charity As a Specified Gift:

As discussed above, specified gifts are a way to transfer gifts from one charity to another charity in a manner that has neutral disbursement quota implications. It should not be assumed, however, that a charity may transfer a 10 year gift to another charity as a specified gift in order to avoid any undesirable disbursement quota consequences. The way the *Act* is currently drafted the transfer of a 10 year gift from one charity to another will be treated as an expenditure of the 10 year gift by the transferor charity, even if the transfer is designated as a specified gift. This will result in the entire 10 year gift being brought into the transferor charity's disbursement quota. The disbursement quota implications of this will not be neutral since the designation of the 10 year gift as a specified gift means that the transfer of it by the transferor charity will not count as a transfer to a qualified donee in satisfaction of the transferor's disbursement quota.²¹

How have low interest rates adversely affected the ability of charitable foundations to meet their disbursement quota?

²⁰ See the definition of disbursement quota under s. 149.1(1) of the *Act*. The definitions of variables A and A.1 exclude 10 year gifts from the 80 per cent disbursement quota until such time as they are expended. However, the definition of variable B, which is applicable only to foundations, brings back into the disbursement quota all gifts received from other registered charities. While the *Act* is not entirely clear on this point (and there are no relevant technical interpretations that we are aware of), it would appear as though a 10 year gift given by a registered charity to a foundation that was excluded from the disbursement quota under variable A will nonetheless be included in the disbursement quota under variable B.

²¹ See the definition of variable "A.1" contained in the definition of "disbursement quota" under s. 149.1(1) of the *Act*. This variable is defined in such a way as to include in the disbursement quota that portion of a 10 year gift that "is expended in the year". Since this definition does not stipulate "expended in the year *otherwise than by way of specified gift*", it makes no difference that the transfer of the 10 year gift is designated as a "specified gift".

Low interest rates have recently revealed a technical problem with the drafting of the disbursement quota requirements in the *Act*. As indicated above, charitable foundations are required to expend an amount equal to 80 per cent of total amount for which charitable gift receipts were issued in the preceding year plus 4.5 per cent of the average value of the foundation's investment property. Gifts of capital received by way of bequest and ten-year gifts are exempt from the 80 per cent disbursement quota requirement until such time as they are expended. At the time that they are expended, the expended portion is subjected to the 80 per cent disbursement quota. (As indicated above, however, the expenditure of a portion of a ten year gift prior to the expiration of the "hold period" may subject the entire gift to the 80 per cent disbursement quota.)

When interest rates are low, a foundation may not be able to meet the 4.5 per cent disbursement obligation without expending a portion of the capital of the bequest or ten-year gift. The difficulty is that the 80 per cent and the 4.5 per cent disbursement obligations are *cumulative*. Therefore, 80 per cent of the expended portion of the capital would be required to satisfy the 80 per cent disbursement requirement and this would leave only 20 per cent of the expended portion to satisfy the 4.5 disbursement obligation.

Consider a gift of capital under a will. If the charity had to draw \$45,000 from capital to satisfy the 4.5 per cent disbursement quota, it would therefore have to expend a total of \$225,000 from capital due to the combined effect of the 80 per cent and 4.5 per cent disbursement quotas. (\$45,000 = 20 per cent of \$225,000 leaving \$180,000, which is 80 per cent of \$225,000, to satisfy the 80 per cent disbursement obligation). CCRA has been made aware of this problem and is looking into it.

What expenditures count towards satisfying the disbursement quota?

Not all expenditures count towards satisfaction of the disbursement quota. In determining whether a charity has met its disbursement quota, only those monies disbursed (i) to qualified donees or (ii) directly on charitable activities should be taken into account.

Qualified Donees:

"Qualified donee" is defined in subsection 149.1(1) of the *Act* to include the following:

- registered charities;
- registered Canadian amateur athletic associations;
- registered national arts service organizations;
- housing corporations resident in Canada constituted exclusively to provide low-cost housing for the aged;
- the United Nations and its agencies;
- universities outside Canada listed in Schedule VIII of the *Income Tax Regulations*;

- charitable organizations outside Canada to which Her Majesty in right of Canada (the federal government or its agents) has made a gift during the charity’s fiscal period or in the 12 months immediately preceding the period;
- municipalities in Canada; and
- Her Majesty in right of Canada or in right of a province (that is, the federal government, a provincial government, or their agencies).

The disbursement of moneys to any of these organizations will count towards satisfying the disbursement quota.

Charitable Activities:

CCRA will consider money to be spent directly on charitable activities when its expenditure is essential to providing the charitable program. This includes the salaries of persons performing, or assisting in the performance of, actual charitable work and disbursements for equipment used in charitable activities. It does not include amounts spent on management, general administration and fund-raising.²²

Money spent on “deemed charitable activities” will not count towards the disbursement quota in all instances. The *Act* deems money spent by charities on certain political activities to be money spent in furtherance of its charitable activities/purposes.²³ Nevertheless, the *Act* provides elsewhere that such expenditures do not count towards the charities’ disbursement quota.²⁴

Once the disbursement quota has been met, can a charity disburse funds to another charity that does not constitute a qualified donee?

The *Act* does not specifically contemplate how a charity may disburse funds *after* it has met its disbursement quota for the year. Nevertheless, in the case of charitable organizations, it is clear that once the disbursement quota has been met, the charity is not free to disburse funds to other charities that do not constitute qualified donees, such as, for example, foreign charities.²⁵ The reason for this is that a charitable organization is by definition a charity that devotes all of its

²² Paragraph 36 of IC 80-10R.

²³ See subsection 149.1(6.1) of the *Act* for charitable foundations and subsection 149.1(6.2) for charitable organizations. The political activities must be ancillary and incidental to the charity’s charitable activities/purposes and must not include the direct or indirect support of, or opposition to, any political party or candidate for public office. For more information on permissible political activities, see Information Circular 87-1 “Registered charities - Ancillary and Incidental Political Activities”.

²⁴ Subsection 149.1(1.1) of the *Act*.

²⁵ Foreign charities are an example of entities that constitute charities at common law but do not necessarily constitute qualified donees. See the definition of “qualified donee” referred to above.

resources to charitable activities carried on by the organization itself.²⁶ An exception to this rule is contained in paragraph 149.1(6)(b) of the *Act*, which provides that a charitable organization may disburse up to 50 per cent of its income to qualified donees and still be considered to be devoting its resources to charitable activities carried on by itself. Since a charitable organization must either carry on charitable activities directly through its own programs or indirectly through limited disbursements to qualified donees, it cannot disburse funds to a foreign charity that does not constitute a qualified donee.²⁷

This is not the case, however, when it comes to charitable foundations. The *Act* requires of charitable foundations that they, *inter alia*, be “constituted and operated exclusively for charitable purposes”.²⁸ In turn, the *Act* defines “charitable purposes” as merely *including* the disbursement of funds to qualified donees.²⁹ In other words, the *Act* does not *restrict* the definition of “charitable purposes” to the disbursement of funds to qualified donees or to the performing of charitable activities directly by a charitable foundation. It would therefore seem that once a foundation has met its disbursement quota for the year (which, as indicated above, requires that the prescribed amount be spent directly on charitable activities or indirectly through gifts to qualified donees), it is free to disburse funds to charities that do not constitute qualified donees.

This practice was approved of by CCRA several years ago. Nevertheless, CCRA recently reversed its position on this issue as is set out in the CCRA Registered Charities Newsletter No. 9 dated June 6, 2000. CCRA now takes the position that neither charitable organizations nor foundations may disburse funds to a charity that is a non-qualified donee even if (i) the donor charity’s disbursement quota is met and (ii) the donee constitutes a charity at common law. Based on this new position, CCRA recently took action against a foundation that was disbursing excess funds available after it had it met its disbursement quota to non-qualified donees. The matter was settled when the private foundation challenged CCRA’s interpretation. In agreeing to settle, CCRA acknowledged that as the *Act* and the regulations passed under it currently stand, the foundation could disburse funds to a non-qualified donee provided that the foundation’s disbursement quota was met and the non-qualified donees constituted charities at common law. The minutes of settlement, however, disclose that the *Act* is likely to be amended in the future to prohibit this practice. Caution is therefore recommended on this front.

What happens if the disbursement quota is exceeded in a particular taxation year?

There will be a disbursement excess for a particular year where all amounts expended by a charity on charitable activities carried on by it or by way of gifts to qualified donees (but not including specified gifts or expenditures on political activities) exceed its disbursement quota for the year.

²⁶ See definition of “charitable organization” in s. 149.1(1) of the *Act*.

²⁷ A charitable organization may, however, *transfer* funds to a non-qualified donee *if* the donee is using the funds on behalf of the organization to carry out the organization’s activities. For more information in this respect, see the CCRA publication called *Registered Charities: Operating Outside Canada* (RC4106E).

²⁸ See definition of “charitable foundation” in s. 149.1(1) of the *Act*

²⁹ See definition of “charitable purposes” in s. 149.1(1) of the *Act*.

A charity can employ a disbursement excess in one of two ways:³⁰

1. The disbursement excess can be applied against a disbursement shortfall occurring in the immediately preceding taxation year; or
2. The disbursement excess can be drawn on for up to five subsequent taxation years to help the charity meet its disbursement quota in those years. The excess expenditures need not be evenly spread over the five years. That portion of a disbursement excess used in one year cannot be used in any of the remaining carryover years.

What happens if the disbursement quota is not met in a particular taxation year?

The *Act* provides that a charity may have its charitable registration revoked for failure to meet its disbursement quota in a particular year.³¹ 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:

1. As indicated above, disbursement excesses from the preceding five taxation years and/or from the immediately subsequent taxation year may be applied against disbursement shortfalls.
2. A charity may apply to have its disbursement quota reduced for the particular taxation year.³² This requires that the charity make an application in prescribed form (T2094). Such an application will be successful only if the disbursement shortfall is due to extraordinary circumstances beyond the charity's control. It is unlikely that such an application would be successful in circumstances where the disbursement shortfall could be remedied through the carryover of disbursement excesses as described above.

How can a charity accumulate funds for large-scale projects and still meet its disbursement quota?

It was indicated above that one of the objectives of the disbursement quota is to prevent charities from accumulating excessive funds. One negative consequence of this is that meeting its disbursement quota can prevent a charity from accumulating sufficient funds to make major purchases out of cash and to thereby escape the interest costs associated with financing such purchases.

There are, however, three basic methods whereby a charity may accumulate property for large-scale projects without running the risk of disbursement shortfalls:

³⁰ Subsection 149.1(20) of the *Act*.

³¹ Paragraph 149.1(3)(b) of the *Act*.

³² Subsection 149.1(5) of the *Act*.

1. It may apply under subsection 149.1(8) of the *Act* for permission to accumulate property. (There is no specific application form.) The application must specify the purpose for which the charity wants to accumulate property, the amount required to be accumulated and the length of time over which the charity will need to accumulate the property.

If the application is approved, then the amount of the property accumulated during each year of the accumulation period, including the income earned on this property, will count towards the charity's disbursement quota in each year. The ultimate expenditure of the accumulated funds at the end of the accumulation period will have no impact on the disbursement quota in the year of expenditure. (This is to avoid having the same funds counted twice towards satisfaction of the disbursement quota.)

If the application is approved and the accumulated property is not used for the specified purpose within the required time, then subsection 149.1(9) requires that the accumulated property, including the income earned on it, be included in the charity's income as receipted income. The timing of this will be the earlier of (i) the expiration of the accumulation period or (ii) the time at which the charity decided not to use the property for the specified purpose. This will increase the disbursement quota requirement for the following taxation year.

2. It can encourage its donors to donate gifts subject to a trust or direction that the gifts, or property substituted for them, be held for at least 10 years. Ten year gifts are exempt from the 80 per cent disbursement quota until the year in which they are spent (at which time the portion of the gift that is expended is subject to the 80 per cent disbursement quota).

It is recommended, however, that caution be exercised when consideration is being given to the disbursement quota implications of ten year gifts. First, as indicated above, not all ten year gifts are exempt from the 80 per cent disbursement quota. Ten year gifts given from a registered charity to a foundation are not exempt from the foundation's 80 per cent disbursement quota. Second, as also indicated above, it is critical to distinguish between the income earned on ten year gifts and capital gains earned on such gifts. The income earned on ten year gifts will in no circumstances be subject to either the 80 per cent or the 4.5 per cent disbursement quotas of foundations. The income earned on ten year gifts can therefore be used to meet the disbursement quota associated with the capital gains earned on ten year gifts.

Capital gains earned on ten year gifts are subject to *both* the 80 per cent and the 4.5 per cent disbursement quotas. Capital gains are subject to the 4.5 per cent disbursement quota because they increase the average value of a foundation's investment property. Capital gains will be subject to the 80 per cent disbursement quota in the year, if ever, in which they are expended (not the year in which they are earned). It should be noted that if capital gains are expended in a year *prior* to the expiration of ten years from the time that the gift was given then the entire ten year gift may be subjected to the 80 per cent disbursement quota in that year (although, as indicated above, the law and administrative practices of CCRA are at present unclear on this point).

3. It can encourage its donors to leave bequests of capital to it. These gifts are not subject to the 80 per cent disbursement quota until the year in which they are expended and even then only to the extent that they are expended.³³ If, however, the gift constituted investment property (as defined above) then it would be subject to the 4.5 per cent disbursement quota applicable to foundations.

Of these three methods of accumulating property for large scale projects the most preferable method will in most instances be to obtain permission to accumulate property under subsection 149.1(8) of the *Act*. This is because unlike the accumulation of ten year gifts and bequests of capital, the accumulation of funds under subsection 149.1(8) will, as indicated above, count towards fulfillment of the charity's disbursement quota in each year of the accumulation period.

How will the redesignation of a charity impact its disbursement quota?

Charities are designated as charitable organizations, public foundations or private foundations. As was indicated above, the disbursement quotas are different for these three "types" of charities. The happening of any event that results in a charity being redesignated will therefore alter the disbursement quota of that charity.

A redesignation may be brought about in two ways: (i) The Minister of National Revenue may exercise his discretion under subsection 149.1(6.3) to redesignate a charity; or (ii) The charity may itself request that it be redesignated by submitting a completed Form T2095, *Registered Charities: Application for Redesignation*.

A charity's designation as a charitable organization, public foundation or private foundation is based mainly on the following four variables:

³³ As indicated above, if the bequest was received prior to 1994 it will *never* be subject to the 80 per cent disbursement quota.

- Source of funding: Charitable organizations and public foundations may not receive more than 50 per cent of their funds from a single person or organization or from a group of people or organizations that do not deal at arm's length. This requirement does not, however, apply to private foundations.
- Disbursement of income. Charitable organizations may not disburse more than 50 per cent of their income to qualified donees. Foundations (both private and public) are not bound by this.
- Composition of board: More than 50 per cent of the trustees, directors, officers or similar officials of charitable organizations and public foundations must deal at arm's length with each other. Private foundations are not bound by this requirement.
- Form of organization. Foundations (both private and public) are required to be in the form of a corporation or trust. Charitable organizations may operate in any form.

A charity must keep these variables in mind so as to avoid inadvertently taking any action that could result in its being redesignated and thereby subjected to a new, potentially more onerous disbursement quota. This could be the case, for example, if a public foundation took any action that could result in its being redesignated as a private foundation. This would result if the public foundation elected board members more than 50 per cent of whom do not deal at arm's length with each other or if it repeatedly accepted very large gifts from a single donor or group of donors that do not deal at arm's length with one another. It should be noted, however, that CCRA has taken the position that it will not redesignate a charity on the basis of it having received a *single* large donation that technically requires the charity to be redesignated.³⁴

³⁴ James Parks, "New Developments and Challenges with Canada Customs and Revenue Agency" at 5. (Paper presented to Canadian Bar Association of Ontario, Friday, October 27, 2000, Fundamental New Developments in the Law of Charities in Canada).