
**NORTH AMERICAN FOUNDATION
6th ANNUAL FOUNDATION ENDOWMENTS
& NOT-FOR-PROFIT INVESTMENTS SUMMIT**

Toronto – October 12, 2006

**Key Legal Issues Regarding Foundations
and Endowments**

By Karen J. Cooper, LL.B., LL.L.
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I. ENDOWMENTS - OVERVIEW

- What Is an Endowment?
- What Are the Advantages of an Endowed Gift?
- What Are the Tax Implications of an Endowed Gift?
- What Are the *Income Tax Act* Requirements of an Endowed Gift?
- What Should Be Considered in Structuring a Donor Endowment Agreement?

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- What Should Be Considered in Structuring a Board Endowment Fund?
- How Should an Endowed Gift Be Managed Once Received?
- What Preventative Steps Can Be Taken To Reduce Liability Involving Endowed Gifts?

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WHAT IS AN ENDOWMENT?

- An endowment is a gift where the capital is held for at least 10 years extending for any period of time thereafter up to in perpetuity
- Normally, an endowment means that the capital is held in perpetuity
- An endowment can be created by either the donor through an endowment agreement (donor endowment agreement) or by the board of a charity initiating the creation of an endowment fund (board endowment fund)
- Under the *Income Tax Act*, an endowed gift is generally referred to as a “ten year gift” under the broader category of “enduring property”

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- The income (e.g. the interest, dividends or realized capital gains) can either be expended in total each year or can be reinvested in whole or in part
- The capital and/or the income can be restricted to a particular use, such as scholarships, or can be left unrestricted and used for the general charitable purposes of the charity
- The disbursement of income and capital by the charity can be left to the discretion of the charity or can be subject to donor advice, e.g. a donor advised fund

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WHAT ARE THE ADVANTAGES OF AN ENDOWED GIFT?

- It permits the creation of a capital fund on a long term or perpetual basis in order to fund either specific projects or the general operation of a charity
- It creates long term stability by balancing against possible fluctuations in yearly fundraising
- It allows donors to create a fund in the name of the donor or their families and have a lasting impact on charitable programs

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- It facilitates the donor acquiring naming rights in relation to the fund in question for a particular project or have naming rights placed on a building for either a specific period of time or in perpetuity
- It permits the creation of both large segregated endowed funds that are initiated by the donor, as well as smaller contributions to existing board endowed funds that are established by the charity
- If an endowment fund is operated through a parallel foundation, then the endowment fund can be protected from creditors of the operating charity

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- WHAT ARE THE TAX IMPLICATIONS OF AN ENDOWED GIFT?**
- Enduring Property**
- An endowed gift, e.g. a gift where the capital is held for at least 10 years or is a bequest or inheritance (now both part of “enduring property”) has tax implications under recent May 2005 amendments to the *Income Tax Act*
- 80/20 D.Q.**
- An endowed gift is excluded from the 80/20 disbursement quota of the recipient charity, provided that the endowed gift is held for at least ten years

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- A transfer of an endowed gift (e.g. enduring property) between a recipient charity and another charity does not affect the 80/20 disbursement quota of either charity
- 3.5% D.Q.**
- An endowed gift, though, will be subject to the 3.5% disbursement quota on investment assets for all foundations and for charitable organizations if the charitable organization received charitable status on or after March 23, 2004, or for charitable organizations after 2008 if they received their charitable status prior to March 23, 2004

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- The 3.5% disbursement quota only applies to those registered charities that hold investment assets greater than \$25,000

Encroachment on Enduring Property

- If interest and dividend income is not sufficient to meet the 3.5% disbursement quota, then the charity can encroach on realized capital gains up to the lesser of the capital gains pool and 3.5% of the investment assets of the charity, provided that the terms of the gift agreement permit such an encroachment during the ten year period

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- Any disbursement of realized capital gains beyond this limit or the disbursement of the original capital will result in 80% of what is expended being added back on to the disbursement quota of the charity
- It is important to ensure that the yearly calculation of the capital gains pool is kept up to date in the T3010 of a charity in order to be able to utilize the capital gains pool in the future in disbursing realized capital gains during the first 10 years of an endowed gift

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- A charity needs to carefully review existing endowment agreements to determine whether the agreement permits encroachment of realized capital gains
- If not, unless the endowment agreement reserves a right to the donor or charity to vary the terms of the endowment agreement, neither the charity nor the donor would be able to encroach on realized capital gains on their own without first obtaining court approval, as the asset no longer belongs to the donor

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Transfer of Endowed Gift

- The transfer of an endowed gift involves the transfer of enduring property and will generally be D.Q. neutral in relation to both the transferor and transferee charity
- But the transfer of enduring property can also be designated by the transferor charity as a specified gift, meaning that the transferee charity will receive the gift free of disbursement quota obligations

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- However, transfers of enduring property as a specified gift will mean that the transferor charity will have the value of the endowed gift added to its disbursement obligation in the year of the transfer but will not have any offsetting credit available to meet that increased disbursement quota in that year

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WHAT ARE THE *INCOME TAX ACT* REQUIREMENTS OF AN ENDOWED GIFT?

- It must meet the statutory requirements under the *Income Tax Act* for a ten year gift
- A ten year gift must be subject to a trust or a direction and be held for a period of not less than 10 years
- The documentation required to evidence a ten year gift must include the following:
 - The document must be executed by the donor for each gift that is made
 - The document must clearly identify the donee charity, including its official name and registration number

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- 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
 - The document must set out the serial number of the official receipt issued to the donor for the gift
 - The information must be attached to charity's duplicate copy of receipt
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- WHAT SHOULD BE CONSIDERED IN STRUCTURING A DONOR ENDOWMENT AGREEMENT?**
- Is there a minimum amount required to establish a donor endowment agreement?
 - Is the fund created by a donor endowment agreement to consist of monies or gifts in kind, e.g. shares?
 - e.g. if it is a gift of shares, then the charity needs to ensure that there is a proper evaluation of the shares done in advance of the gift
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- Do the proposed anti-tax shelter provisions apply pertaining to the valuation of the gift?
 - e.g. possible "grind down" of FMV to the ACB of the property if it is acquired within 3 years or within 10 years if it was reasonable to conclude that the donor had an intent to make a gift
 - e.g. will the proposed expanded definition of "advantage" under the proposed split receipting rules limit the eligible amount of the gift for receipting purposes?
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- **Is the capital of the fund to be held in perpetuity or for a period of at least 10 years?**
- **During the first ten years, is the charity to have the ability to encroach on realized capital gains?**
- **If the fund is to be held for at least 10 years, but not in perpetuity:**
 - **When can the capital be expended after 10 years?**
 - **What is the capital to be used for at that time, e.g. are there any restrictions which apply?**

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- **For a fund that is to be held in perpetuity, can the charity encroach on the capital after 10 years and if so, under what circumstances?**
 - **e.g. meeting the yearly disbursement quota shortfall**
 - **e.g. in the event of extenuating circumstances encountered by the charity in the discretion of the board**

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- **Are further contributions of capital permitted and, if so, are there any limitations?**
 - **From whom can the contributions be received?**
 - **Are the imposition of further limitations to be permitted?**
 - **Are there time or quantum limitations on further contributions?**

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- **What is the purpose of the fund, e.g. is there to be a restriction in relation to the use of the income and/or capital or can the income and/or capital be used for the general charitable purpose of the charity?**
- **Is the application of the income/capital to be structured as a “donor advised fund” and if so, is it clear that the board of the charity must ultimately exercise its discretion over the expenditure of the income and/or capital as opposed to that of the donor?**

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- **Is the investment policy of the charity to be incorporated by reference into the endowment agreement or is the donor allowed to impose specific investment terms of reference on the gift?**
 - **Does the prudent investor standard from the *Trustees Act* apply?**
 - **Does the charity have an investment policy?**
 - **Does the charity have an agency agreement to delegate investment decision making to an investment manager?**
 - **Is the donor able to impose restrictions on the type of investment and what happens if the restriction no longer are prudent in the circumstances?**

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- **Is the charity to be able to charge a reasonable administrative charge against the income of the endowment fund?**
- **Are the details of an administrative charge contained in the endowment agreement or is it to be cross-referenced to the gift policy of the charity**
- **Does the charity have a disbursement policy to determine how much income is to be paid out each year from the endowed fund and how much is to be reinvested and under what circumstances there can be an encroachment on capitalized income and capital?**

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- Does the endowment agreement permit a transfer of the endowed fund and change of trustee to another charity, such as a parallel foundation?
- Does the endowment agreement include a *cy prés* type of clause to permit the charity to change the purpose of the gift in the event that the original purpose becomes impossible or impractical?
- Does the endowment agreement need to include a determinable gift to protect the endowed gift by requiring it to be transferred to another charity in the event of the insolvency, bankruptcy or winding up of the charity?

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- Does the endowment agreement permit amendments to the administrative terms of the agreement?
- Does the endowment agreement address due diligence concerns under anti-terrorism legislation?
 - e.g. has the charity conducted appropriate due diligence enquiries of the donor?
 - e.g. has the charity retained a discretion not to apply the endowed fund to the restricted purpose in the event of anti-terrorism concerns?

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- Is the donor to be given naming rights? If so:
 - How long do the naming rights extend for?
 - Has the charity retained the right to terminate the naming rights of a donor and under what circumstance?
- Does the charity wish to reserve the right to refuse or even return a gift and if so under what circumstances?
 - e.g. criminal conviction?
 - e.g. immoral conduct?
 - e.g. concerns about terrorist activities?

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- If a gift is to be returned, what are the tax implications to both the charity and the donor?
- A gift over to another charity may be a better option than simply returning the gift to the donor
- Has the donor been advised to seek independent legal and/or tax advice?
- Has the charity ensured that there is no evidence of undue influence involved in the donor making the endowment
- Has the board of a charity authorized the signing of the endowment agreement and who has signing authority on behalf of the charity?

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- WHAT SHOULD BE CONSIDERED IN STRUCTURING A BOARD ENDOWMENT FUND?**
- The board of the charity should create the terms of a board endowment fund by adopting a board resolution
 - There should be a board resolution to authorize each board endowment fund
 - The substantive terms of a board endowment should generally be similar to the terms of a donor endowment agreement as described above

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- Example of board endowed funds could include for example
 - A perpetual endowment fund
 - A building fund
 - A debt reduction fund
 - A specific project fund
 - A scholarship fund

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- Have the terms of the board endowment fund been adequately communicated to the donor in writing or is it available at the website of the charity?
- Is there some form of an endowment fund contribution agreement in order that the donor can evidence in writing that the gift meets the requirements of a ten year gift under the *Income Tax Act*?

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HOW SHOULD AN ENDOWED GIFT BE MANAGED ONCE RECEIVED?

- Identify the nature of the endowed gift to determine if it is actually an enforceable donor restricted gift or a “precatory trust” that is not enforceable
- Review and approve donor restrictions before receiving the gift
- Effective ongoing management of endowed gift includes
 - Depositing the endowed gift into the bank account of the named charity

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- Invest the endowed fund in accordance with applicable investment powers
- Do not borrow against the endowed gift
- Commingle endowed gift only in accordance with the regulations in the *Charities Accounting Act (Ontario)* and not with any general funds of the charity
- Always comply with the terms of the applicable restrictions

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WHAT PREVENTATIVE STEPS CAN BE TAKEN TO REDUCE LIABILITY INVOLVING ENDOWED GIFTS?

- Public fundraising appeals should state that any surplus funds resulting from a campaign for endowed funds will be used for the general charitable purposes of the charity
- Ensure that an endowed gift includes a *cy prés* clause that will allow the charity to vary the purpose of the gift if the original purpose becomes impossible or impractical
- Recommended that documentation creating endowed gift include the words “in trust” in accordance with recent case law

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II. STRUCTURAL CHANGES - OVERVIEW

- Background
- Audit Process
- Intermediate Sanctions and Penalties
- Practical Considerations

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BACKGROUND

- New rules concerning the taxation and administration of charities set out in the 2004 Federal Budget received Royal Assent on May 13, 2005 and are now in force:
 - New intermediate sanctions and penalties
 - New and more accessible appeals process
 - CRA’s internal appeals process
 - Tax Court of Canada
 - Also new DQ rules and increased transparency previously discussed

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- **Previously, CRA had only one sanction – revocation**
- **Relatively few audits**
- **Audits usually reactive, not proactive**
- **Audits performed by Consulting and Audit Canada, not CRA**
- **Budget brought increased resources to the Charities Directorate at CRA**

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AUDIT/APPEALS PROCESS

- **CRA is gradually providing some guidance with respect to the process related to the implementation of the new rules which it believes is consistent with the graduated educative approach to compliance recommended by the Voluntary Sector Initiative’s Joint Regulatory Table report**

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- **CRA’s Progressive Approach:**
 1. **Education (specific and general)**
 2. **Compliance Agreements**
 3. **Intermediate Sanctions**
 4. **Revocation**

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INTERMEDIATE SANCTIONS AND PENALTIES

- **Purpose of Intermediate Sanctions**
The May 2005 amendments establish a more responsive approach to the regulation of charities under the *Income Tax Act* by introducing sanctions that are more appropriate than revocation for relatively minor breaches of the *Income Tax Act*
The sanctions will apply in respect of taxation years that begin after March 22, 2004

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Offence	First Infraction	Repeated Infraction (Within 5 years)
• Late filing or failure to file T3010A	• \$500 penalty	• \$500 penalty. • May lead to revocation
• Issuing incomplete receipts	• Penalty of 5% of eligible amount stated on receipt	• Penalty of 10% of eligible amount stated on receipt
• Carrying on prohibited business activity • Private foundation - any business • Public foundation or charitable organization - unrelated business	• Tax of 5% on gross revenue from the offending activity	• Tax of 100% on gross revenue from the offending activity and suspension of receipt privileges
• Foundation acquiring control of corporation	• 5% tax on dividends paid to charity	• 100% tax on dividends paid to charity
• Failure to comply with certain verification and enforcement requirements (e.g. keeping proper books and records)	• Suspension of tax receipting privileges	• Suspension of tax receipting privileges

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Offence	First Infraction	Repeated Infraction (Within 5 years)
• Issuing receipts in taxation year if there is no gift or if receipt contains false information	• 125% tax on eligible amount of receipts (suspension of tax receipting privilege of total penalties under 188.1(9) exceeds \$25,000 in a taxation year)	• 125% tax on eligible amount of receipts (suspension of tax receipting privilege of total penalties under 188.1(9) exceeds \$25,000 in a taxation year)
• Transfer among charities to avoid disbursements quota (joint and several liability with recipient charity)	• Tax of amount transferred and 10% of amount transferred	• Tax of amount transferred and 10% of amount transferred
• Undue personal benefit	• Penalty of 105% of benefit	• Penalty of 115% of benefit and suspension of tax receipt privileges

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TAX/PENALTY

- Sanctioned charity can transfer the amount of tax or penalty to CRA or to another arm's length charity (eligible donee)
- Arm's length – more than 50% of directors deal at arms length with all directors of the sanctioned charity

REVOCACTION

- Still available for any offence and can be applied with intermediate sanctions
- The charitable status of a charity may also be revoked if it obtained its charitable registration status on the basis of false, misleading or omitted information

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ANNULMENT

- Where registration obtained in error or if charity ceases to be a charity because of changes in the law
 - No effect on issued receipts
 - No 100% Part V revocation tax or other penalty will be charged
- Useful tool – permits errors to be rectified without negative public notice which goes with notice of revocation

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PRACTICAL CONSIDERATIONS

- Perfection is not expected or required
- But need to exercise due diligence

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BOOKS AND RECORDS

- Financial records
- Receipts and supporting documentation
- Records demonstrating charitable nature and that all activities have a charitable purpose
- Keep notes and copies of all documents and correspondence
- Privileged documents (communications related to obtaining legal advice, does not include accountants or consultants)

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INCOMPLETE RECEIPTS

- Income Tax Regulation 3501 requires:
 - Name, Registration # and address of charity
 - Serial # of receipt
 - Date and place of issue
 - Date of receipt of cash gift
 - Date of receipt and description of in-kind gift
 - Value of property received
 - Amount of advantage received by donor
 - CRA name and website URL
- See CRA Website for most recent requirements

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UNDUE BENEFIT

- Gifts other than to qualified donee
- The amount of any “rights, income, property or resources” paid, payable, assigned or otherwise made available to member or trustee of the charity, or a person who contributed more than 50% of the capital of the charity, or a non arms length person

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