



Use of Private and Public Foundations

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Introduction

- As of December 2005, the charitable sector comprised 82,243 charities. Of these 4,208 were private foundations, 4624 were public foundations and 73,391 were charitable organizations – CRA Newsletter #27 Fall 2006
- 2 divergent trends in Canada's charitable and not for profit sector
 - tremendous growth in the charitable sector since the 1960's
 - Significant and continuing cutbacks in government spending on the arts, education and health care
- To ease the pressure on not for profit sector, federal government introduced changes to Act to encourage charitable gifting through enhanced tax incentives

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Introduction

- These tax changes have blurred the distinctions between public foundations and charitable organizations but have imposed onerous restrictions on the funding and activities of private foundations as compared with other charities as exemplified most recently by recent rules introduced in 2007 Budget excess business holdings


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Introduction


- Purpose of this talk
 - examine rules applicable to private foundations and other types of charities and consider this differential treatment in the context of donors' motivations in selecting a specific vehicle for their charitable giving
 - explore advantages and limitations of private foundations
 - consider public foundation as alternative to private foundation


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Introduction


- ITA contemplates charities will be designated as one of:
 - charitable organization or charitable foundation
 - foundation in turn is further characterized as public or private foundation
- Designation will affect:
 - disbursement quota
 - rules relating to gifts made to each type of charity
 - activities/investments that are permitted
 - activities/investments that are prohibited


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Charitable Organization: overview

- Devotes all of its resources to charitable activities carried on by the organization itself
- May be established as a corporation, trust or unincorporated association
- Cannot be controlled by a group of related directors/officers/trustees
- No part of the income of the charity may be payable or otherwise available for the personal benefit of any proprietor, member, shareholder, trustee or settlor
- Typically is primarily engaged in direct charitable activity


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Charitable Foundation: overview

- Constituted and operated exclusively for charitable purposes
- May carry on limited amount of charitable activity but generally provides funding to charitable organizations or "qualified donees" to permit them to carry on their charitable activities
- May be established as a corporation or trust but not as an unincorporated association
- No part of the income of the charity may be payable or otherwise available for the personal benefit of any proprietor, member, shareholder, trustee or settlor

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Charitable Foundation: overview

- Charitable foundation may be either a public foundation or private foundation
- Public foundation, like a charitable organization, cannot be controlled by a group of related directors/trustees/officers/like officials
- Private foundation is defined in the Act as a charitable foundation that is not a charitable organization or a public foundation

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Charitable Foundation: overview

- Proposed changes to the definition of public foundations and charitable organizations: contribution test replaced by control test
- Reason for proposals was to permit charitable organizations and public foundations to receive large gifts without concern that they might be deemed to be private foundations

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Charitable Foundation: overview

- Prior “contributions “ test provided that if more than 50% of the capital of a charity was contributed from one donor or a donor group, charity would be deemed to be a private foundation and thus subject to more stringent disbursement requirements and restrictions on activities and investments
- Bill C-10 (first reading October 30, 2007) reflects amendments first introduced in December 2002 which introduced “control” test. When enacted these amendments will be retroactive to January 1, 2000.

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Control Test

- The control test provides that a charity can be designated as a charitable organization or public foundation even if a donor donates more than 50% of the capital of the charity , so long as the donor or donor group does not exercise control over the charity directly or indirectly or is in a non- arm’s length relationship with 50% or more of the directors/trustees/officers/like officials of the charity

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Charitable Foundation: overview

- Exemption for funds from federal or provincial government, municipalities, other registered charities that are not private foundations or non profit organizations

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Charitable Foundation: overview


- As result of proposed rules, when applying “control” test some registered charities may find that they are able to apply under ss. 146.1 (6.3) of the Act to change their designation. This must be done within 90 days after the Bill receives Royal Assent and will then be deemed to be registered as charitable organizations, public foundations or private foundations as the case may be in the taxation years that the Minister specifies


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Reasons for Establishing & Gifting to a Private Foundation


- Donor retains control
 - over assets donated
 - over investments
 - over timing of gifts to foundation and timing of gifts made by foundation
 - over quantum of distributions
 - over activities of charity
- Donor can involve family members – instill altruistic values

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Reasons for Establishing & Gifting to a Private Foundation

- Donor can retain privacy
- Conversely, may bring donor public recognition and identification with foundation’s charitable work
- Donor can design own charitable programs and causes charity will support
- Foundation can be used to build up asset base for charitable work
- Foundation can hold endowment funds or make endowed gifts

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Factors Limiting Attractiveness of Private Foundation

- Increased administrative and financial requirements
- Must follow required corporate procedures
- Corporate filings
- Filing annual Registered Charities Information Return (Form T3010)
- Must keep adequate books and records
- Must issue donation receipts in accordance with requirements under the Income Tax Act
- Succeeding generations may not have same philanthropic objectives as original donor...who will mind the store after the founder is gone?

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Factors Limiting Attractiveness of Private Foundation

- Subject to applicable provincial statutes
 - in Ontario → PGT has jurisdiction
 - Charities Accounting Act
 - ss. 2(2) – if charity holds private company shares, corporation must furnish financial information to PGT if required to do so

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Factors Limiting Attractiveness of Private Foundation

- Charitable Gifts Act
 - charities prohibited from holding more than 10% of an interest in a business – must dispose of excess within 7 years
 - if charity holds more than 50% interest in business – charity and PGT must meet to determine profits of corporation and what percent to distribute
 - investment restrictions

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Factors Limiting Attractiveness of Private Foundation

- applicability of CGA is dependant on what is meant by "interest in a business"
 - charity holds more than 10% of voting shares of business?
 - charity holds more than 10% of any single class of shares?
 - charity holds more than 10% of total issued capital?
 - charity shareholdings entitle it to more than 10% of the profits?
 - charity holds debt instruments reflecting an amount equal to more than 10% of capital of business corporation?
 - charity through its holdings can appoint more than 10% of the directors?

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Factors Limiting Attractiveness of Private Foundation

- Trustee Act
 - Prudent investor rule
- Income Tax Act
 - More stringent rules apply to private foundations than to public foundations and charitable organizations

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Income Tax Act Provisions Affecting Private Foundations


- Business activity
 - public foundations and charitable organizations can carry on related businesses
- Private foundation cannot carry on any business activities
 - caveat re holding investment structures in form of limited partnerships. CRA considers charity to be carrying on the business of the limited partnership (CPS-019 "What is a related business")

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Income Tax Act Provisions Affecting Private Foundations


- If private foundation carries on business or a public foundation or charitable organization carry on a business that is not a related business it could:
 - have its charitable designation revoked (149.1(4)(a))
 - be liable for monetary penalty ranging from 5% to 100% of its gross revenues from the business for repeated infractions (188.1(1) and (2) and 188.2(1))


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Borrowing


- Private foundations and public foundations cannot incur debt other than debts for current operating expenses, purchase and sale of investments, or the administration of charitable activities (149.1(4)(d))
- The rule also applies to public foundations but not to charitable organizations


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Borrowing

- CRA administrative position – this allowed only certain types of debt such as brokerage fees or other incidental amounts related to purchase or sale of investments but not debt for purposes of purchasing investments or using loan proceeds to discharge debts permitted under the Act at the time debt was incurred


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Borrowing

- Technical Interpretation (2005-015475117, October 2005) – CRA reverses position
 - says a foundation is permitted to incur debt for purposes of acquiring investments
 - also now permitted for members and directors of foundation to lend money interest free to enable foundation to acquire investments, pay current operating expenses or expand on charitable activities
 - CRA will continue to monitor debt arrangements, in particular in non-arm's length situations; one other concern is whether there is a "personal benefit"

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Control of Other Corporations

- Private and public foundations prohibited from acquiring control of any corporation (149.1(3)(c) and 149.1(4)(c))
- Foundation could have its charitable registration revoked or may be liable for a monetary penalty
- Penalty can range from 5% to 100% of the dividends paid by the corporation (ss.188.1(3))

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Control of Other Corporation

- Test for whether the charity controls the corporation varies with the penalty sought to be assessed
- Where penalty is monetary penalty – charitable foundation will be considered to control corporation if charity itself or together with persons dealing at non-arm's length with charity hold more than 50% of issued share capital having full voting rights (149.1(12))
- Does not matter if charity purchased shares or received them as gift

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Control of Other Corporation

- Where penalty is loss of charitable status, charitable foundation will be deemed not to have acquired control provided it has not purchased or otherwise acquired for consideration more than 5% of any class (voting or otherwise) of shares of the corporation
- Thus, a gift of any percentage of shares will not result in charitable foundation being considered to control the corporation
- This relieves charitable foundation from extreme penalty of loss of charitable registration but monetary penalties would still apply

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Non-Qualifying Securities (NQS)

- Mechanism for blocking gifts (testamentary or inter vivos) of private company shares and debt that fall into category of NQS to private foundations
- NQS defined in ss. 118.1(18)
 - shares in a corporation with which donor does not deal at arm's length immediately after the gift/bequest is made or obligation owed to donor by such a corporation and also includes other non-arm's length transactions

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Non-Qualifying Securities (NQS)

- NQS does not include a security listed on any of the prescribed stock exchanges set out in Regulation 3201
- Also excepted is a gift which is a share (but not debt) donated to either a public foundation or charitable organization (but not private foundation) with which donor deals at arm's length and where donor deals at arm's length with each director/trustee/officer/like official of recipient charity

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Non-Qualifying Securities (NQS)

- When a donor donates a NQS to a private foundation, a donation tax receipt will not be issued at time when donation is made
- Receipt will be issued if within 5 years of the donation either the recipient private foundation disposes of the NQS or the NQS ceases to be a NQS
- Value of receipt issued will be lesser of
 - fmV of security at time of donation as modified by any designation under 118.1(6)
 - fmV of the consideration received by the charity on disposition of the NQS or where NQS ceases to be NQS, then fmV at that time

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Non-Qualifying Securities (NQS)

- Donor who makes gift of NQS and realizes a gain on the disposition may claim a reserve under ss. 40(1.01) during the 5 year period until gift deemed to have been made
- Gifts of private company shares by donor who controls corporation or gifts of debt of a donor's corporation are NQS and subject to the rules

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Loan backs


- Applies to gifts to private foundation
- Two situations will trigger application of loan back rules set out in ss. 118.1(16) or 118.1(17)
 - donor makes regular gift to private foundation and within 5 years of the gift, the private foundation allows donor (or non-arm's length person to donor) who is non-arm's length to private foundation to use the foundation's property within certain time frame – 118.1(16)(c)(ii) – tax credit will be denied

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Loan backs

- non-arm's length donor makes regular gift to private foundation and within 5 years the private foundation acquires a NQS from or of the donor
 - tax credit in respect of first gift will be denied (118.1(16)(c)(ii))
- Donor must be careful not to inadvertently trigger the loan back rules

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Non-Qualified Investments and Section 189

- If private foundations holding non-qualified investments (NQI), taxpayer will be subject to a penalty tax under ss. 189 of the Act if the interest payable to the foundation does not meet a minimum rate of return
- NQI includes a debt, a share or a right to acquire a share

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Non-Qualified Investments and Section 189

- In the case of a debt it must be owing to the private foundation by:
 - a person who is a member, shareholder, trustee, settlor, officer, official or director of the foundation or
 - a person who either alone or as a member of a group that does not deal with each other at arm's length has contributed more than 50% of the capital of the foundation or
 - a person who does not deal at arm's length with any person described above


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Non-Qualified Investments and Section 189


- In the case of a corporation, a debt will be a NQI of the corporation if controlled by the private foundation, by any person or group of persons described above, by the foundation and any other private foundation with which it does not deal at arm's length, or by any combination of the above
- Will include a share in the capital stock of a corporation referred to above, held by the foundation, or held by persons not dealing at arm's length with the foundation
- Shares listed on a prescribed stock exchange either within or outside Canada will not be included


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Non-Qualified Investments and Section 189


- E.g. a mortgage that a private foundation acquired from a director.
 - the mortgagee must complete Form T2140, Part V Tax Return – Tax on Non-Qualified Investments of a Registered Charity, every fiscal year.
 - the tax payable can be reduced by the amount of interest paid during the tax year.
 - accordingly if the mortgagee decided to voluntarily pay interest to the foundation, it would reduce the amount of tax payable
- See CRA Registered Charities Newsletter No. 27 (Fall 2006)


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Disbursement Quota


- All registered charities are required to expend a portion of their assets each year in accordance with a disbursement quota (DQ)
- The DQ is designed to ensure that an appropriate percentage of the funds donated to a charity are used in charitable activities/purposes (80% test) and to restrict the excessive accumulation of such funds or expenditure of such funds on administrative and fund raising expenses (3.5% test)


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Disbursement Quota


- New DQ rules enacted on May 13, 2005 (Bill c. 33, 2005) and apply generally to taxation years beginning after March 22, 2004 except that for charitable organizations registered before March 23, 2004, the 3.5% DQ will only apply to their taxation years beginning after 2008
- New DQ rules for charitable organizations and public foundations are now the same, subject to some transitional provisions


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Disbursement Quota


- Briefly – 2 main elements
 - charitable organizations/public foundations 80% of donations for which receipts were issued in prior years, subject to some exceptions such as 10 year gifts
 - 3.5% of value of investments determined on a rolling average basis
 - private foundations – some exceptions - must expend 100% of gifts received from other charities (other than specified gifts and enduring property)


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Capital Gains Tax to Donors and Tax Credits


- Tax credits provided for gifts by individuals to charities
- In general donors making gifts in kind to a charity deemed to have disposed of the gifted asset at fair market value – generally this will result in realization of a capital gain
- In 1997 amendments to the Act provided that deemed disposition resulting from gift of publicly listed securities to a public foundation or charitable organization only taxable at ½ the usual capital gains rate


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Capital Gains Tax to Donor


- 2006 Federal Budget: removed all capital gains tax on gifts of publicly listed securities to a charitable organization or public foundation
- 2007 Federal Budget extended this benefit to gifts of publicly listed securities to private foundations on or after March 19, 2007. Will also be available to gifts of publicly listed securities acquired by arm's length employee under options granted by employer and donated within 30 days after exercise.


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Excess Business Holdings Regime


- 2007 Federal Budget also introduced excess business holdings regime applicable to private foundations "Prior to this charitable foundations only required to disclose to CRA the value of investment assets but not required to disclose the specific securities held
- Proposed new rules to address self dealing opportunities and to complement intermediate sanctions introduced in 2004 and will place limits on foundation shareholdings that take into account the holdings of persons not dealing at arm's length with the foundation

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Excess Business Holdings Regime

- Will apply to private foundations and to both publicly-listed and unlisted shares
- New regime identifies three ranges of shareholdings with different implications for the foundation for each range.
- First range: Safe Harbour : if foundation's holdings in a corporation for each class total 2% or less of all outstanding shares of that class - No need to monitor or report holding of any non-arm's length person to CRA

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Excess Business Holdings Regime

- Second range: Monitoring phase: if foundation's holdings of one or more share classes exceed 2 % of outstanding shares of that class, foundation must determine and report to CRA shares held at end of year in all share classes by foundation and non arm's length persons. Foundation must also report in its annual information return any material transactions (acquisition or sale involving over \$100,000 worth of shares of a class or more than .5% of all outstanding shares of that class) during year by foundation or non-arm's length persons

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Excess Business Holdings Regime

- Third range: Divestment Required : where foundation and all non-arm's length persons together hold more than 20% of all outstanding shares in any share class of a corporation. Foundation will be subject to penalties unless combined holdings of foundation and its non-arm's length persons reduced to 20% or less of that share class within certain time periods or until holdings of foundation do not exceed 2%

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Examples of Actions Required by a Foundation*

| | Private Foundation (Holdings of share Class) | Non-Arm's Length Persons (Holdings of Share Class) | Action Required by a Foundation |
|------------------------|--|--|--|
| 1. Safe harbour | 2% or less | Any percentage | None |
| 2. Monitoring phase | 5% 10% 20% | 10% 10% 0% | Reporting required |
| 3. Divestment required | 25% 8% 10% Above 2% | 0% 14% 17% Above 18% | Reduce holdings to 20% Reduce holdings to 6% ¹ Reduce holdings to 3% ¹ Reduce holdings to 2% ¹ |

¹ Alternatively, non-arm's length persons could reduce their holdings until the combined holdings of the foundation and non-arm's length persons did not exceed 20%.


* Extract from Federal Budget Supplementary Information March 19, 2007

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Excess Business Holdings Regime

- Transitional period from 5 to 20 years for private foundations to sell off existing excess holdings. Those foundations that have not completed their transition by end of their first taxation year beginning on or after March 19, 2012 will not qualify after that time for the zero inclusion rate for capital gains on donations of publicly traded securities.

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Excess Business Holdings Regime

- New regime will have serious effects on tax planning involving private foundations
- Greater difficulty in building up value of assets of private foundation and will restrict ability of private foundations to fund charitable activities
- Advantage to private foundations of privacy will be lost due to new reporting requirements
- Advantage to private foundations of extension of the zero capital gain on gifts of publicly traded securities offset by this new regime
- Charities currently designated as private foundations but which may qualify as public foundations or charitable organizations under the new "control" test may wish to consider requesting re-designation.

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Advantages of Public Foundation

- Public foundations generally have arms length board, come in variety of forms
- Parallel foundations act as fund raising and fund administering entity for an operating charity such as hospital, art gallery, museum and the like
- Other foundations have a broader focus in many cases acting as an umbrella foundation for numerous operating charities on a national or international scale
- Between these is the community foundation which seeks to support charitable works in a particular region

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Advantages to Public Foundation

- New excess holdings regime does not apply
- Use of public foundation offers simplicity, ease of administration and cost savings
- Year end gifting is assured whereas if desire to establish private foundation and make charitable gift toward year end may encounter delays at CRA
- No concern as to whether future generations will have same zeal and vision as initial donor
- Flexibility offered to donors in that at time of making a gift, donor can direct, through use of donor advised fund agreements, that the gift be used to create a fund for a purpose and can also direct the gift to be held in perpetuity or for a period of time and also give directions as to distributions of income/capital
- Donor recognition is possible

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Disadvantages of Public Foundation

- Personal satisfaction of operating a charity and opportunity to instill charitable values in family members may be lost when administration relinquished to community foundation
- Fewer advantages of timing and scheduling of charitable distributions : with a gift to private foundation the eventual charitable use of the gift can be determined later while with public foundation decisions must be determined at time of the gift

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Public Foundations


- And what about donor control? To what extent can public foundation approximate benefits of private foundation in this area?
- Donor advised funds can only go so far to avoid argument that the donation was not a gift because donor retained too much control
- Charity receipt can be given for a gift subject to trust restrictions so long as trust obligations do not benefit the donor or persons non arm's length to the donor
- Recognition and use of a donor's name will in most instances not taint the gift

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Conclusion

- Donor advised funds make gifting to public foundation attractive alternative to establishing a private foundation
- Restrictions imposed on private foundations still more onerous than on public foundations and charitable organizations
- Some clients will still want to consider use of private foundations

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Conclusion

- Factors to Consider – Establishing a Private Foundation
 - Is there any charity that donor would feel comfortable donating to that would meet the donor's philanthropic desires and achieve donor's tax and estate planning
 - What would be the charitable objects of the private foundation and what types of charitable causes would the foundation support?
 - What should be the legal form of the private foundation?
 - Under what jurisdiction should the foundation be incorporated?

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Conclusion

- Factors to Consider cont'd
 - How should foundation be structured? Who would be on board and how would donor exercise control on foundation? Does donor have other trusted family members who can sit on board?
 - Will the foundation receive funds from the donor, family members or other individuals?
 - Will the foundation hold endowed funds or grant endowed gifts?
 - Will the foundation be a passive funder or will the foundation carry on active charitable programs?

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