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Considerations in Creating Endowed Gifts
and Gift Planning in Troubled Times

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PART I. OVERVIEW - ENDOWMENTS

- How does an Endowment work?
- What Are some Advantages of an Endowed Gift?
- Difference between Restricted and Unrestricted gifts
- ITA Implications and Requirements
- Donor Endowment Agreements & Board Endowment Funds
- Management of Endowments
- Endowments in a Troubled Economy

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IN A NUTSHELL - HOW DOES AN ENDOWMENT WORK?

- Created by either a donor through an endowment agreement or by the board of a charity
- Involves the creation of a capital fund to be held on a long term or perpetual basis in order to fund either specific projects or the general operation of a charity
- 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

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- 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 its discretion or can be subject to donor advice, e.g. a donor advised fund

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WHAT ARE SOME OF THE ADVANTAGES OF AN ENDOWED GIFT?

- It can create 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 in order to have a long term impact on charitable programs
- It facilitates the donor acquiring naming rights for a particular project or have naming rights placed on a building

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- The vehicle is flexible enough to permit the creation of both large segregated endowed funds as well as smaller contributions to existing board endowed funds
- 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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UNRESTRICTED AND RESTRICTED CHARITABLE GIFTS

- An endowed gift is held by a charity as a restricted charitable gift
- It is therefore important to know the difference between an unrestricted and a restricted charitable gift
- What is an unrestricted charitable gift?
 - It is a gift at law to be applied towards the general charitable purposes of a charity that is not subject to any restriction by the donor
 - If a board designates a gift to a specific charitable purpose, the board can change its mind and apply the gift to another special purpose as long as it is within its charitable objects

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- Examples of unrestricted charitable gifts
 - Cash donations
 - Government grants not restricted to a specific program
 - Gifts from donors that are directed to be used for the general purposes of a charity
 - Board designated funds that are internally restricted

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- What is a restricted charitable gift?
 - It is a gift at law that is subject to restrictions imposed by the donor that constrain how a charity can use the gift
 - Charity must understand the nature of the restriction that has been imposed and the importance of complying with the restrictions
 - There are different forms of legal restrictions with corresponding distinct legal consequences

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- **Example of Donor Restricted Charitable Gifts**
 - **Endowment Funds**
 - See previous definition of an endowment
 - Restricted in time for 10 years or more
 - **Restricted Use Funds**
 - Capital and earned income to be expended over a period of time rather than being held for 10 years or more
 - Will be applied in accordance with certain specific charitable purpose restrictions
 - restrictions will eventually be fulfilled, thereby bringing the restricted gift to an end

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- **Restricted Charitable Trust Property**
 - Real estate that is acquired subject to certain terms of trust contained in the deed of the property that can act as a type of an endowment
 - Three general categories of restrictions:
 - Pertaining to use
 - Pertaining to religious doctrine
 - Limiting the use of the property to those who follow a particular religious practice

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- **Implied Restricted Charitable Gifts**
 - Courts have been prepared to consider extrinsic evidence concerning whether the donor intended to create a restricted charitable gift
 - e.g., instead of a formal gift agreement, the court can look at a letter or a memorandum of discussions with a donor to determine his or her intent

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– Precatory Trusts/Designated Gifts and Donor-Advised Funds

- Precatory trust is a non-binding request of the donor and is also called a designated gift
- Do not have any enforceable restrictions associated with them
- Donor gives “suggested direction” which is an expressed preference, desire or request
- Moral obligation on charity receiving such a gift

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- Donor advised fund is a form of designated giving whereby the donor makes a gift to a charity and then periodically makes nonbinding recommendations as to the distribution of assets from the fund
- Allows donor to receive immediate tax deduction for a charitable gift while deferring the ultimate disbursement of the gift for future charitable projects

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- According to CRA, a donor can require a gift to be used in a particular program provided that the decision regarding use of the donation within the program rests with the charity
- If donor retains too much control over the gift it will no longer be considered a gift at law, in which case it cannot be receipted under the ITA

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

- Under the *Income Tax Act* (ITA) an endowed gift is referred to as a “10 year gift” under the broader new category of “enduring property”
- The statutory requirements for a 10 year gift is that it 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 10 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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TAX IMPLICATIONS OF AN ENDOWED GIFT

Enduring Property

- An endowed gift (i.e. a gift where the capital is held for at least 10 years or a bequest or inheritance now both forming part of enduring property) has tax implications under the recent May 2005 amendments to the ITA

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 between a recipient charity and another charity does not affect the 80/20 disbursement quota of either 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 for taxation years commencing 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 for the charity to vary the terms of the endowment agreement, neither the charity nor the donor would be able to permit encroachment 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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WHAT SHOULD BE CONSIDERED IN STRUCTURING A DONOR ENDOWMENT AGREEMENT?

- Amount of the donation - is it above any minimum amount established by the charity's gift acceptance policy for a donor endowment?
- Is the donation a gift of monies or gift in kind?
 - if a gift in kind, then the charity needs to ensure that there is a proper evaluation done in advance of the gift to determine FMV
 - the value of a gift of securities will generally be the closing bid price of the shares on the date of the gift

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- Is the capital of the fund to be held in perpetuity or for a period of at least 10 years?
- Is the charity to have the ability to encroach on realized capital gains?
- Is the charity to be given the ability to encroach on the original capital?
- Note if encroachment on capital within the 10 year period, then the whole gift collapses (no longer a 10 year gift)

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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 a 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 there time or quantum limitations on further contributions?
 - Need to track further contributions as new ten year gifts for Income Tax purposes

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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?
- 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?

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- Does the donor wish to have continuing involvement in decisions regarding the application of the income/capital of the fund? If so, the agreement will be structured as a “donor advised fund”
- Is the endowment agreement clear that the board of the charity will ultimately exercise its discretion over the expenditure of the income/capital?

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- Is the investment policy of the charity to be incorporated by reference into the endowment agreement?
- If not, is the donor able to impose restrictions on the type of investment in relation to the gift?

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- Is the charity 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?

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- 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?
- If no policy a provision in this regard should be set out in the endowment agreement

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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 provisions to protect the endowed gift by requiring it to be transferred to another charity in the event of a pending 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?
- 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?

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- 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 to authorize the same
- 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?

- **Review and approve donor restrictions before receiving the gift, as there is no obligation to accept a gift**
- **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**
- **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 gifts 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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ENDOWMENTS IN A TROUBLED ECONOMY

- **Undoubtedly most charities with significant capital invested in the markets are feeling some pain**
- **Donors who pledged major gifts of appreciated capital stock may take a “wait and see” approach to donating since:**
 - **Drop in value of shares either means more must be given or gift must be scaled back or reduced to value of shares**
 - **Tax Incentives work best when gain is high**

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- **No immediate relief in terms of the DQ based on value of endowments – any relief based on smaller net values follows the market shift later (since DQ operates on a time-lag or averaging basis)**

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ENDOWMENTS IN A TROUBLED ECONOMY – WHAT CAN YOU DO?

- **Include ability to encroach on capital in endowment agreements in order to meet DQ**
- **Consider providing for a reasonable administrative fee to be charged against endowment to offset some of the costs of its administration**
- **Refer back to your charity’s gift acceptance policy in deciding what gifts to accept, i.e. just because times are tough don’t say “yes” to every big gift that comes your way. Having clear gift policies in place will help you avoid getting stuck with donations that can create a burden on the organization later**

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- **Be realistic - The problem of over-promising and under-delivering: Don't promise to do 10 things just to get an endowed gift. Consider that the endowed gift won't spin off income right away so where will the unrestricted money come from to get things underway?**
- **If this is the case, consider asking donor to make part of gift unrestricted and not subject to the 10 year rule**
- **Charities should closely monitor investments and where needed, modify investment policies to minimize risk**
- **Don't commit "recession suicide" – charities should avoid making the mistake of cutting fundraising expenditure. Focus on protecting future revenue - not just services today**

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PART II. GIFT PLANNING - OVERVIEW

- **Elimination Of Taxable Capital Gains in Respect Of Certain Gifts**
- **Charitable Remainder Trusts**
- **Use of Private Foundations, Community Foundations and Donor Advised Funds**
- **Bequests**
- **Other Deferred Gifts**

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A. ELIMINATION OF TAXABLE CAPITAL GAINS IN RESPECT OF CERTAIN GIFTS

1. **Gifts of publicly traded-shares**
 - **The tax on capital gains incurred on the donation of publicly listed shares and ecologically sensitive property has been completely eliminated**
 - **Generally, a gift of property will trigger a capital gain if the fair market value ("FMV") of the property exceeds its adjusted cost base ("ACB")**

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- For most gifts of property, 50% of the capital gain is included in income for the year and is subject to tax
- For example, a gift of shares that an individual paid \$100 for (the ACB) and which now has a FMV of \$1,000, would have resulted in a capital gain of \$900 and a taxable capital gain (the amount she will have to include in her taxable income) of \$450

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- Now, with the Budget 2006 measures, a donation of publicly traded shares or an ecological gift with an ACB of \$100 and a FMV of \$1,000 will result in no taxable capital gain
- Therefore, the entire amount of the donation tax credit of \$460 will be available to be used against other sources of income
- This makes donations of such property even more attractive than cash, since the cost of the donation to individual in the first place was only \$100

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- This type of gift is the most vulnerable to the current market volatility
- Timing is everything
 - Avoid being the financial advisor
 - Rely on a clear gift acceptance policy - see *Registered Charities Newsletter No. 12*
 - Usually the date of the gift is the date that the shares have been received in the charity's brokerage account

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- **Limited opportunities still exist**
 - BCE shares
 - Donors may want to trigger taxable capital losses, but be careful
 - Donors may want to donate and re-purchase in order to step up the ACB of shares that remain winners over the long-term

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2. Flow-Through Shares

- **Flow-through shares (sometimes referred to as “FTS”) are tax-based financing incentives available only to the oil and gas and mining sectors**
- **The current rules effectively permit corporations to renounce or “flow-through” income tax deductions associated with certain activities to shareholders in exchange for the sale of their shares**

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- **An investor receives shares issued by the corporation as consideration and the deductions available to the corporation in relation to resource expenditures are flowed-through to investor**
- **The expenditures deducted by the investor grind the cost base of the shares**
- **The impact of the elimination of the tax on capital gains accruing on donations of publicly traded securities when coupled with tax incentives on FTS issued by companies in the resource sector has generated great interest and planning opportunities for investors in this sector**

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- **Advisors to donors and charities with respect to such gifts should be careful when considering such gifts since many FTS are subject to hold periods, may not retain their value during the hold period, and may not be marketable upon the expiration of the hold period**

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- **However, a number of advance income tax rulings have recently been issued sanctioning various structures using FTS (see also 2007APFF Question)**
- **These rulings all relied on “liquidity providers” to avoid the hold periods – these have disappeared entirely from the current market**

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B. CHARITABLE REMAINDER TRUSTS

- **Rules related to charitable remainder trusts have not kept pace with other changes to the sector**
- **Rules not expressed in the ITA, based on CRA technical interpretations and administrative positions**
- **Rules currently under review, but may have become attractive again in the current market**

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- A charitable remainder trust is an irrevocable trust which has been created by a settlor/donor who gifts a residual (or remainder) interest in a property to a trust for the benefit of a registered charity or qualified donee (collectively referred to in the remainder of this section as a “charity”) while retaining the right to use and enjoy the property, including the right to receive income from the property for a specified period (usually the settlor’s life)

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- The settlor receives an immediate donation tax receipt and is able to immediately claim a donation tax deduction or credit in respect of a deferred gift while continuing to enjoy the property or receive income therefrom
- The favourable treatment given to charitable gifts of publicly listed shares does not apply to shares used to fund a charitable remainder trust, but in the current market such treatment may not be beneficial

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C. USE OF PRIVATE FOUNDATIONS, COMMUNITY FOUNDATIONS AND DONOR ADVISED FUNDS

- As of December 2005, CRA indicates that there were 4,208 private foundations registered with CRA (out of a total of 82,243 registered charities) (CRA Registered Charities Newsletter No. 27, Fall 2006)
- Community foundations currently number 165
- The effective use of a private or community foundation or a donor advised fund could be a very useful and flexible planned giving tool for an individual even in troubled economic times

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Advantages for the donor:

- Donor can retain control over assets
- Donor can retain control over the investments of donated assets
- Donor may involve other family members in the foundation/fund and instill altruistic philanthropic values in them
- Donor now no longer vulnerable to market volatility

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Advantages for Beneficiary Charity

- Because of the 3.5% disbursement quota requirement there should be a steady stream of income
- Ensures a continued relationship with the donor that may be maximized in better times
- But be wary of the issues raised in respect of endowments

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D. BEQUESTS

- The ITA provides tax relief to a donor for charitable gifts during his/her life time
- Tax relief is even greater for gifts made as a result of the donor's death
- Making charitable gifts through wills may be done in a variety of ways
- The availability of the donation tax credit will depend on the circumstances in each case and the manner in which the will is drafted

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- Subsection 118.1(5) deems a gift made by an individual's will to have been made by the individual immediately *before* death
- Subsection 118.1(4) provides that a gift made in the year of death is deemed to have been made in the year immediately prior to death to the extent that the tax credit for the gift has not been claimed in the year of death

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- Donation tax credit may be claimed in the individual's terminal tax return or in the year immediately prior to death
- Donations made in the year of the donor's death and the immediately preceding year could be deducted up to 100% of the deceased's income in those years
- Where a gift made as a result of a person's death does not satisfy the requirements under subsection 118.1(5), the estate or the testamentary trust may be entitled to a charitable donation credit pursuant to subsection 118.1(3)

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E. OTHER DEFERRED GIFTS

1. Life insurance

- Donor may irrevocably assign the ownership and beneficiary rights of paid-up life insurance policy to Charity
- Irrevocably assign the ownership and beneficiary rights of a life insurance policy to Charity on which premiums remain to be paid; or
- Name the charity as a beneficiary of a life insurance policy

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2. Registered retirement plans

- **Includes direct designation of a charity as a beneficiary to receive the proceeds of RRSPs or RRIFs on the death of the donor**
- **Also can gift to a charity the proceeds of RRSPs or RRIFs on the death of the donor by way of bequest**

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3. Charitable gift annuities

- **An arrangement under which a donor irrevocably transfers property to a charitable organization in exchange for immediate guaranteed payments for life at a specified rate depending on life expectancy or for a fixed term**
- **A portion of the property is used to purchase a commercial prescribed annuity from a licensed issuer**
- **The cost of the annuity is based on the donor's age and income requirements**

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- **The remainder of the property not required to purchase the annuity is considered an outright gift to the charity**
- **The licensed issuer or the annuity pays the donor a guaranteed income for a specific time or for the remainder of the donor's life**
- **Upon death of the donor, the charity receives any remaining guaranteed income from the annuity, unless the donor has specified otherwise**
- **Charitable foundations may not be able to enter into arrangements to issue annuities, since an undertaking to make an annuity payment may be considered a debt, which is a ground for revocation under the *Income Tax Act***

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