

Encroachments on Enduring Property

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INTRODUCTION

- The current economic downturn has resulted in lower returns from investments and sharp decline in value of capital.
- For charities this means that charitable programmes they have been funding are at risk
- Charities are turning to their endowment funds to determine
 - whether and to what extent they can encroach on capital to fund commitments and to meet disbursement quota obligations.
 - whether they can or should change their investment strategy

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INTRODUCTION (con't)

- The answer to these questions requires a review of the regulatory framework pertaining to endowment funds.
- The rules derive from the Federal Income Tax Act (Canada) and Provincially from the common law relating to trusts and statutes such as the Trustee Act, The Charitable Gifts Act and the Charities Accounting Act.

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ENCROACHMENT ON CAPITAL

- Starting point: If the income is insufficient is encroachment permitted?
- Must review:
 - terms of the gift
 - trust law/Charities Accounting Act
 - Income Tax Act (Canada)

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Types of Endowments

- 10 year gifts
- donor restricted gifts (inter vivos/testamentary)
- trust law considerations
- board restricted gifts
 - board may be able to change use

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Relevant Considerations

- Terms of the gift
 - ability to expend income/capital
 - is capital to be held for a term of years or in perpetuity?
 - restrictions on types of investments?
 - are restrictions internal or external?
- trust law issues
- donor relations

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Is the endowment a trust

- Trusts
 - intention of settlor
 - property or subject matter
 - beneficiaries-objects
- a gift given subject to trust or direction that it is to be held for 10 years
- What is a direction? If it is an obligation to hold property (or property substitute therefor on certain terms – appears to be a trust)
- So even if not called a trust – arrangement will almost invariably establish a trust – see CRA Dcc # 2008-0031495 where CRA describes enduring property as a trust at law

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If Gift is a Trust

- cannot encroach on capital if terms of trust do not permit encroachment
- variation by court order
- or s. 13 Charities Accounting Act (Ontario)
- Stillman Case
 - total return policy
 - encroachment based on % of value of the assets

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Role of Public Guardian and Trustee

- in Ontario ...authority to regulate charities
- must be served if court application
- parens patriae role filled by Attorney General in other provinces

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Internally Restricted Funds

- Board can create a fund to which the donors contribute
- Board can set aside unrestricted funds and make them applicable to a particular purpose
- If wish to amend or vary the terms: What can be done? donor expectations..what were they?
- need to review terms and see whether flexibility may have been built in

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Income Tax Act

- Disbursement Quota (DQ)
- requires that a prescribed amount be disbursed by charity each year
- purpose
 - to ensure that charity's funds are used to further its charitable purposes
 - to discourage charities from accumulating excessive funds
 - keep other expenses at a reasonable level
- With minor differences, the DQ for charitable organizations, public and private foundations is essentially the same

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Computation of DQ

- $A + A.1 + B + B.1$
- A= 80% of prior year's tax receipted gifts other than enduring property and amounts received from other charities
- A.1= enduring property spent or transferred less capital gains pool
- B= gifts received from other charities
- B.1 = 3.5% of the average value of the charity's investment property.

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Enduring Property

- gifts of enduring property are generally excluded from the DQ of a charity in the year they are received and included in the year the funds are spent or transferred
- not all types of enduring property are the same or subject to the same restrictions
- bequests, life insurance proceeds, RRSP/RRIF funds are forms of enduring property
- nothing in the ITA requires that there be restrictions on how such funds are to be used by the charity or whether capital/income to be expended
- need to review terms of gift (donor agreement/will) to determine what restrictions there may be
- In contrast 10 year gifts do contain restrictions found in the ITA

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Calculation of DQ – A and A.1

- A= 80% of all gifts for which a receipt was issued in prior year with exception of enduring property and amounts received from other charities
- A.1 = sum of
 - 80% of enduring property expended in the year
 - +
 - 100% of enduring property transferred to a qualified donee (another charity)
- less the lesser of
 - 3.5% additional DQ
 - and
 - capital gains pool for the year

So A.1 can be reduced if charity has a capital gains pool and has encroached on the capital of a 10 year gift.

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Calculation of DQ - B.1

- B.1 = 3.5% DQ requirement calculated on the charity's investment assets
- It is also relevant because it is used in the definition of a 10 year gift

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Capital Gains Pool

- a charity is permitted to reduce its DQ for amounts encroached up to 3.5% of investment assets if it has a capital gains pool
- Capital gains pool is a notional account. It is the total of all capital gains realized from the disposition of enduring property since March 22, 2004 less enduring property gifted and prior permitted encroachments
- capital gains pool can record capital gains not just relating to capital gains realized on 10 year gifts but on capital gains realized on all enduring property

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Why is it relevant

- If charity encroaches on a 10 year gift, it must include 100% (if transferred to another qualified donee) or 80% (if expended on activities) of the amount in the DQ calculation of A.1 in the year
- this gives rise to the possibility of double counting as 3.5% of the value of the capital would have also been added to the DQ under B.1
- If charity has a capital gains pool it would reduce the A.1 of the DQ calculation by the lesser of 3.5% of the value of the investments and the capital gains pool

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EXAMPLE

- | | |
|---|----------|
| • Assume only asset of charity is 10 year gift. | \$100000 |
| • Interest and dividends on gift (2 percent return) | \$2000 |
| • 3.5 % of capital value. | \$3500 |
| • Charity wishes to encroach | \$3500 |
| • DQ calculation | |
| • A.1. 80 % of \$3500 = | \$2800 |
| • B.1 is 3.5 % of \$100000 = | 3500 |
| • Total DQ is 2800+3500 = | \$6300 |
| • Amount available to spend is | \$5500 |
| • So have shortfall | |
| • If had capital gains pool could have reduced DQ | |

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Failure to Meet the DQ may result in Revocation of Charity Status

- Dealing with DQ shortfall
- DQ excess can be carried forward for 5 years
- Charity may apply to Minister to reduce DQ (ss. 149.1(5) and Form 2094)
- application will not be considered till after year is over and permission will be granted only if shortfall is result of circumstances beyond the charity's control

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CRA Views – Question 1

- On April 22, 2009 CRA released set of questions and answers relating to the treatment of enduring property for purposes of the DQ
- Question 1 deals with how fund agreements define income. For example some fund agreements talk about earnings and don't distinguish between interest, dividends, capital gains. The question clarifies that the gift agreement considers these items as current earnings and the capital refers to the dollar value of the original gift

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CRA Views – Question 1 (con't)

- CRA Response: such gifts may not qualify as enduring property. The gift must be subject to a trust or direction to the effect that the property given or property substituted for the gift is to be held by the charity or by another registered charity for at least 10 years. Realized and unrealized capital gains relating to the original property gifted to the charity or substituted property form part of the gift subject to this holding period. Therefore where fund agreements allow the charity to expend these capital gains prior to the end of the 10 year period the gift may not qualify as enduring property unless such expenditures do not exceed the amount determined for a taxation year by B.1 in the DQ formula (ie 3.5% DQ requirement)

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CRA Views – Question 2

- Question 2 concerns encroachments on the capital of a 10 year gift to meet the DQ where the terms of the gift permit encroachment.
- CRA response: a charity is permitted to encroach on the capital of a 10 year gift within the minimum 10 year holding period to the extent of the amount determined for a taxation year by B.1 in the formula of its DQ (ie the 3.5%). There is nothing in the ITA that says that a charity can only encroach when it cannot meet its DQ and the response did not address this point

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CRA VIEWS – Question 3

- Question 3: if a charity does not track capital gains pools will this inhibit its ability to encroach on capital.
- CRA response: a failure to track capital gains pool does not inhibit a charity's ability to encroach on capital as the rules permit encroachment up to the 3.5% DQ requirement regardless of the capital gains pool balance. However where a charity has not kept track of its capital gains pool the charity will be limited in its ability to reduce its DQ requirement. Tracking the capital gains pool allows a charity to reduce its DQ requirement. If a charity does not track its capital gains pool it will be unable to determine the amount of the reduction to which it is entitled.

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CRA VIEWS – Question 4

- Question 4: Does a charity have to track every single 10 year gift to determine when the respective holding periods are over.
- CRA response: Charities are required to track every 10 year gift they receive separately. Each 10 year gift must be subject to a trust or direction that it be held for at least 10 years subject to the exception discussed above as the minimum 10 year holding period applies to each gift received by the charity

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CRA VIEWS – Question 5

- Question 5 and the CRA response clarifies that the fact that a charity has a DQ excess will not preclude it from encroaching on the capital of its 10 year gifts provided it is otherwise permitted to do so by the terms of the gift.

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CRA VIEWS – Question 6

- Question 6 deals with a charity's fund agreements that include the ability to encroach on capital to cover its administration fees and investment management fees.
- CRA response: This may be a concern as such gifts may not qualify as enduring property. Where fund agreements allow a charity to encroach on capital to cover administration and investment management fees and provided that such fees will not exceed the B.1 amount (ie 3.5% DQ requirement) these gifts may qualify as enduring property. However if the administration and investment management fees exceed the amount determined under B.1 the gifts may not qualify as enduring property.

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CRA VIEWS – Question 6 (cont'd)

- CRA also notes that encroachments on capital will factor into the DQ calculation (see discussion above regarding double counting) and furthermore amounts spent on administration fees and investment management fees are not charitable expenditures and cannot be used to satisfy the DQ.

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CRA VIEWS – Question 7

- Question 7 clarifies whether encroachment amounts should be reported on line 5710 of the T3010 as amounts spent in the taxation year and that these amounts will create a 80% DQ requirement in the following year.
- CRA response: enduring property expended in the taxation year will impact a charity's DQ in the taxation year in which the property is expended. Enduring property spent in the taxation year should be reported on line 5710 of the T 310. The charity will have an 80% DQ requirement under element A.1 of the definition of DQ
- if the enduring property is transferred to a qualified donee then 100% DQ requirement and it should be reported on line 5060 of the T3010.

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CRA VIEWS – Question 8

- Question 8 addresses the inability of a charity to meet its DQ in 2009 because of the current financial crisis. CRA confirms that where a charity fails to meet its DQ due to unforeseen consequences that are beyond its control it may apply for relief under subsection 149.1(5) of the Act. Relief will only be granted under extraordinary circumstances. The reader is referred to policy commentary CPC-029 Application for DQ relief. (see also form 2094)
- CRA reminds charities that a charity must file the annual information return form T3010 within 6 months from the end of the charity's taxation year or risk losing its registration. In passing it is noted that form T3010B has recently been released and must be used by all charities for fiscal years ending on or after Jan 1, 2009.

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CREA VIEWS – Question 9

- Question 9 deals with the treatment of an encroachment on the capital of a 10 year gift.
- CRA indicates if the terms of the fund agreement permit the charity to expend a portion of the property gifted in excess of the amount determined for element B.1 (ie 3.5%) the gift will not qualify as enduring property and 80% of the gift may be required to be included in component A of the formula for the charity's DQ in the taxation year subsequent to the year in which the gift was made
- Where a portion of a gift that qualifies as enduring property is expended generally 80% of the amount spent and 100% of amounts transferred to qualified donees is required to be reflected in A.1 of the DQ in the taxation year that the amount was expended or transferred. The remainder of the gift will similarly be included in A.1 in the formula for the taxation year(s) in which the amount is expended

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THANK YOU
