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Implications of Disbursement Quota Reform

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OVERVIEW

• Pre-2010 Budget DQ rules
• Reform efforts
• 2010 Budget DQ rules
• CRA’s Steps
• Implications of new DQ rules
(current as of April 20, 2010)

A. PRE-2010 BUDGET DQ RULES
1. Background
   • Disbursement quota is prescribed amount that registered charities must disburse each year in order to maintain charitable registration
   • Purposes of DQ
     – Curtail fundraising costs
     – Limit administration costs
     – Limit capital accumulation
     – Ensure significant resources devoted to charitable activities
   • DQ introduced in 1976
   • Rules reformed per 2004 Budget - became more complex
2. **80% DQ and 3.5% DQ**

- A charity must spend each year on charitable activities (including gifts to other charities) what is at least equal to 80% DQ + 3.5% DQ
- Failure to meet DQ is grounds for revocation
- **80% DQ ("charitable expenditure rule")**
  - The sum of
    - 80% of gifts receipted in the immediately preceding year (except gifts of enduring property and gifts received from other charities)
    - 80% of enduring property expended in the year and 100% of enduring property transferred to qualified donees in the year, less optional reduction by realized capital gains on enduring property
    - 80% of gifts received from other charities (except specified gift or enduring property) (100% for private foundations)

- **3.5% DQ ("capital accumulation rule")**
  - Must expend 3.5% of assets not used directly in charitable activities or administration ("investment assets")
  - Based on the average value of assets in 24 months immediately preceding the taxation year
  - 3.5% DQ does not apply if property is $25,000 or less
  - Detailed calculation in Income Tax Regulations 3700, 3701, and 3702
  - See *Charity Law Bulletin* No. 150 at [http://www.charitylaw.ca](http://www.charitylaw.ca)
3. Difficulties
• Complicated rules
• Complicated concepts (enduring property, capital gains pool, capital gains reduction, ten-year gifts, inter-charity transfers, specified gifts)
• Arbitrary (80%, charitable vs. administration, 10-year gift)
• Lack clarity re charitable vs. administration
• Not take into account diversity of Canada’s charitable sector
• Undue burden on small charities

• 3.5% DQ not sensitive to real market returns and unrealistic in economic downturn
• Limits capacity of charities to disburse funds (either in following year or at least after 10 years)
• Presents inaccurate perception to the public
• Restrictions on use of capital in donation agreements make it difficult for charities to access capital to comply with DQ obligations

B. REFORM EFFORTS
• CRA Fundraising Guidance released June 11, 2009
  – Regulates fundraising costs and fundraising practices
  – Fundraising ratio: fundraising costs to fundraising revenue in a fiscal year
    • 35% or less - unlikely to generate questions or concerns
    • 35 to 70% - CRA will examine average ratio over recent years to determine if there is trend of high fundraising costs
    • Over 70% - will raise concerns with CRA and will likely result in revocation
CBA Concept paper to Finance

- July 2009
- Four regulatory objectives pursued by current DQ regime
  (1) Current gifts disbursement
  (2) Anti-accumulation
  (3) Administrative efficiency – via increased transparency
  (4) Fundraising efficiency – via CRA Fundraising Guidance

Objectives (1) + (2) = prevention of undue accumulation of donations, income and capital
- Made recommendations for reform to simplify DQ
- Supported by Imagine Canada, CAGP and other organizations in the charitable sector

C. 2010 BUDGET DQ RULES

- Changes proposed
  - Repeal of 80% DQ
  - Repeal of 80% DQ related concepts
    - Enduring property (including ten-year gifts)
    - Capital gains pool
    - Specified gifts
  - Increased threshold for 3.5% DQ to $100,000 for charitable organizations (remained at $25,000 for foundations)
Expanded anti-avoidance provisions

- Where it can reasonably be considered that purpose of a transaction was to delay unduly or avoid application of DQ
- To ensure amounts transferred between non-arm's length charities will be used to satisfy DQ of only one charity

(1) A charity entered into a transaction and it may reasonably be considered that purpose of the transaction was to avoid or delay unduly expenditure on charitable activities
  - “Transaction” includes gifts to other charities
  - May be grounds for revocation
  - 110% penalty of expenditure delayed or avoided
  - Where gift to another charity - both charities are jointly and severally, or solitarily, liable for the penalty

(2) A gift received from non-arm's length charity will need to be expended by following year (in addition to its 3.5% DQ)
  - Unless the transferor charity elects that gift will not count toward satisfying its own 3.5% DQ (“designated gift”)
  - Otherwise grounds for revocation
  - 110% penalty of fmv of the property exceeds the amount expended
CRA will be given discretion to exclude accumulated property from 3.5% DQ

- CRA has discretion to allow charities to accumulate property for a particular purpose, such as a building project
- Currently, property accumulated (and income earned) with CRA approval is deemed to have been spent on charitable activities
  - Effective for fiscal years that end on or after March 4, 2010
  - Finance will monitor effectiveness of CRA’s Fundraising Guidance and take action if needed to ensure its stated objectives are achieved

D. CRA’s STEPS

- CRA update April 1, 2010
- CRA indicated it will make administrative changes, will release Q&A
- CRA will produce new instructions on how to calculate DQ for fiscal years that end on or after March 4, 2010
- Form T3010B will be revised to reflect new DQ calculation (charities must continue to use existing form until a new form is released)

E. IMPLICATIONS OF NEW DQ RULES

1. Generally
   - Welcomed change
   - Simplicity of DQ calculation
   - Ease administrative burden for charities (especially small and rural)
   - No need to spend scarce resources accounting for and allocating expenses between charitable vs administrative expenses for 80% DQ, but concept still needed for meeting 3.5% DQ
Increase of $100,000 threshold for charitable organizations allows them greater ability to maintain reserves to deal with contingencies

Questions on anti-avoidance provisions

Questions on transition, application and implementation

2. Inter-Charity Transfers

Transfer between non arm’s length charities - to be expended by following year, unless designated gift

- Not transfers between arm’s length charities
- When to designate a gift
  - If gift would not be expended by transferee charity the following year
- Effect of designating a gift
  - Transferor charity has to meet its own 3.5% DQ with other expenditures

Possible problem

- e.g. charity setting up a new parallel foundation and move endowments over to foundation
- Should not be penalized
- Solution?
  - Transfer what transferee charity needs to spend by following year
  - Designate gift if transferor charity has other expenditure to meet its 3.5% DQ

When would inter-charity transfers be recognized as a transaction to “avoid or delay unduly expenditure”?
3. Transactions to Avoid or Delay Unduly Expenditure
   • “Transaction” includes “gift to another registered charity”
   • Lacks clarity
     – What does “avoid or delay unduly” the expenditure mean?
     – Would this include a charity receiving an endowment from a donor?

4. Existing Endowments
   • What to do with existing endowment funds, long-term gifts and ten-year gifts?
   • Questions
     – Can capital be encroached?
     – Still need to track 10-year period?
     – Still need to track hold period?
   • Need to review all existing gift agreements and trust provisions

- Whether can encroach will depend on language of agreement
  – Does agreement permit encroachment of capital or expenditure of income only?
  – Does language specifically allow encroachment up to capital gains pool?
    With capital gains pool repealed, what to do?
  – May need cypres court order to vary terms
    • If terms impractical or impossible
    • E.g. Ontario – section 13 of Charities Accounting Act
• Internally restricted endowment funds?
  – Where charity sets up a fund for the public
to make donations to
  – Review fundraising and promotion
    materials – to determine terms of funds
  – Donor’s intention?

5. New Gifts
• No need to struggle with structuring long-term
gifts or endowment funds to comply with
  complex ITA language related to enduring
property
• Flexibility in structuring new gifts – can focus
  on balancing:
  – Donor desires for long-term financial
    stability
  – Need for flexibility to meet changing
    economic conditions

• Encroachment
  – Ability to encroach capital?
  – Discuss with donor under what
    circumstances
• Income and capital
  – May be remove reference to income and
capital
  – Use total return investment and payout
    strategy instead
• Length of hold period
  – 10 year is no longer a “magic number”
  – Discuss with donor appropriate length
  – May be “long term” rather than perpetuity
• Other gifting issues to discuss with donor, e.g. payout strategies, investment strategies, administrative fees, donor advice, variance clause, flexibility, etc.
• Revise template gift documents to remove reference to enduring property, 10-year gifts, capital gains pool etc.
• Revise internal policies, e.g. gift acceptance policies, endowment fund policies, etc.
• Revise publications, e.g. website, promotion materials, donor communications, etc.
• Educate donors and staff

6. Corporate Sponsorships
• To receipt or not to receipt?
• No 80% DQ concerns if receipted
• But receipt needs to reflect fmv of marketing/advertising value received by sponsor

7. Fundraising Guidance
• With 80% DQ repealed, more focus on compliance with CRA’s Fundraising Guidance
• 2010 Budget indicates that part of CRA’s Fundraising Guidance has strengthened CRA’s ability to ensure that a charity’s fundraising practices are appropriate
• Released June 11, 2009
• Regulates fundraising practices
• Regulates fundraising costs
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31. Fundraising ratio: fundraising costs to fundraising revenue in a fiscal year
   - 35% or less - unlikely to generate questions or concerns
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32. Guidance provides information on current treatment of fundraising under ITA and common law (not a new CRA policy position) on
   - Distinguishing between fundraising and other expenditures
   - Allocating expenditures for T3010 reporting
   - Dealing with activities that have more than one purpose
   - Understanding how CRA assesses what is acceptable fundraising
   - Fundraising expenditure cannot be used to meet 3.5% DQ

33. Other Issues
   - Disbursement excess and shortfall
     - What to do if DQ shortfall? Same CRA policy?
     - Application of DQ excess?
       - § 149(20) and (21) re DQ excess not proposed to be changed
       - Windfall? (e.g. if transferred $1 million endowment to arm’s length charity, lots of DQ excess for future use?)
   - Outstanding CRA permission to accumulate
     - How would these apply?
   - CRA audits
     - What if charity under audit not meeting its 80% DQ for years being audited?
9. Steps to be Taken by Charities

- Watch for CRA clarifications and enactment of ITA changes
- Revise internal documents
  - Policies, e.g. gift acceptance policies, endowment fund policies, etc.
  - Template documents, e.g. endowment agreements, bequest clauses, etc.
  - Publications, e.g. website, promotion materials, etc.
- Staff training
- Communication with donors, more transparency
- Consult legal and accounting advice where uncertain

F. CONCLUSION

- Welcomed change
- Simplicity of DQ calculation
- Still many unanswered questions
- Needs CRA clarification

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