HEALTHCARE PHILANTHROPY:
CHECK-UP 2010

June 10, 2010

What the Federal Budget Disbursement Quota Reform Will Mean to Your Charity

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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 June 6, 2010)

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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**

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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")
  - 80% of gifts receipted in the immediately preceding year (except gifts of enduring property and gifts received from other charities)

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  - 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)

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- 3.5% DQ ("capital accumulation rule")
  - 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.chairtylaw.ca

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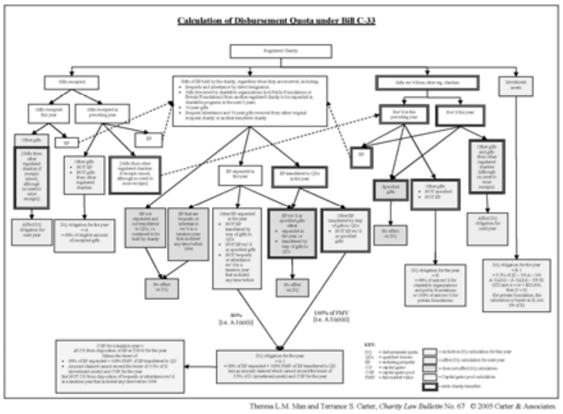

3. **Problems**

- **Complicated rules**
- **Complicated concepts (enduring property, capital gains pool, capital gains reduction, ten-year gifts, inter-charity transfers, specified gifts)**
- **Hard to characterize expenses - arbitrary**
  - **Administration**
  - **Charitable**
  - **Fundraising**

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- **80% & 3.5% spending & 10 year hold**
  - **Arbitrary**
  - **Not take into account diversity of Canada's charitable sector**
  - **Undue burden on small charities**
  - **Not sensitive to real market returns**
  - **Capital vs income concept not reflect investment strategy**
  - **Limits capacity of charities to disburse funds (either in following year or at least after 10 years)**
  - **Restrictions on use of capital in agreements make it difficult for charities to access capital to comply with DQ obligations**

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- Administrative costs
  - Rigid
  - Confusion whether encroachments to cover administration and investment management fees out of capital of enduring property tainted the enduring property
  - Not recognize charities are different
- Presents inaccurate perception to the public

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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

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- CBA Concept paper to Finance July 2009
  - Four regulatory objectives pursued by current DQ regime
    (1) Current gifts disbursement - prevent undue accumulation
    (2) Anti-accumulation - prevent undue accumulation
    (3) Administrative efficiency – via increased transparency/disclosure
    (4) Fundraising efficiency – via CRA Fundraising Guidance
  - Supported by Imagine Canada, CAGP and other organizations in the charitable sector

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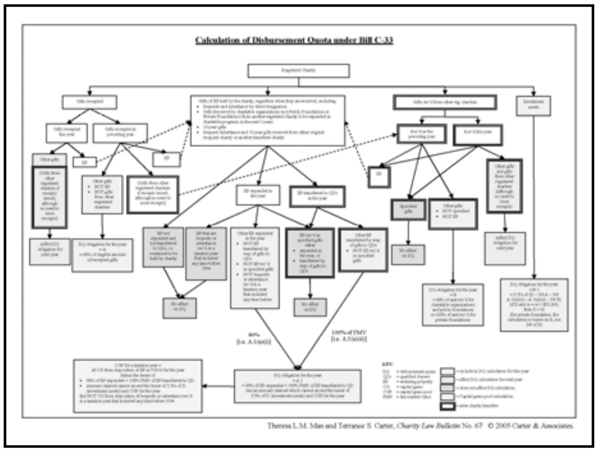

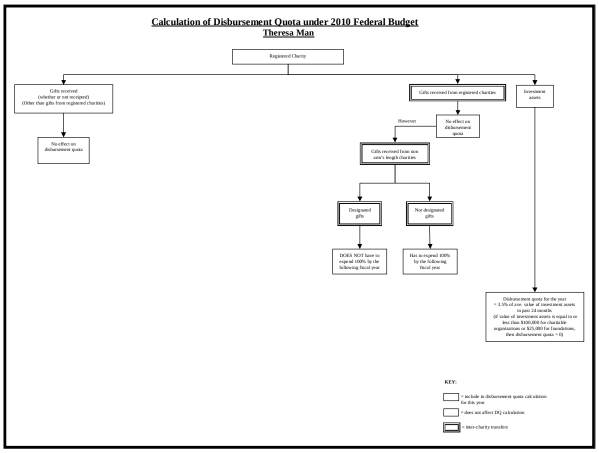

C. 2010 BUDGET DQ RULES

- **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)**

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- 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

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(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

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(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

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- 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

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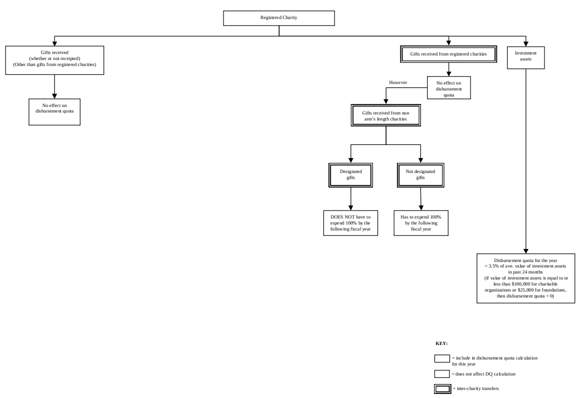
Calculation of Disbursement Quota under 2010 Federal Budget
Theresa Man



D. CRA's STEPS

- March 31, 2010 - Message from the Director General
- April 27, 2010
  - T3010B instruction sheet (interim measure), revised T3010 to be released later
  - Detailed line-by-line instruction on how to complete the current T3010B form for charities with a fiscal period ending on or after March 4, 2010

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- If fiscal year ended before March 4, 2010, changes will not affect filed return or return yet to be filed
- Instruction does not deal with:
  - "designated gifts" to be exclude from 3.5% DQ calculation
  - *de minimis* threshold for 3.5% DQ for charitable organizations increased to $100,000
  - accumulated property for which approval was obtained from CRA to be excluded from 3.5% DQ calcuation

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- May 3, 2010 - CRA released a list of 15 questions and answers on new DQ rules
- May 4, 2010 - new CRA webpage
- Form T3010B will be revised to reflect new DQ calculation (continue to use existing form until a new form is released)
- CRA will continue to provide updated information on the impact of the 2010 Budget through its webpage, forms and publications, phone enquires services, and other communication channels

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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

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- **Increase of $100,000 threshold for charitable organizations allows them greater ability to maintain reserves to deal with contingencies**
- **No need to track receipted vs non-receipted gifts**
- **No need to track 10-year expiration for 10-year gifts**
- **Questions on anti-avoidance provisions**
- **Questions on transition, application and implementation**

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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**

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  - **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"?**

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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?

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4. Existing Endowments

- What to do with existing endowment funds, long-term gifts and ten-year gifts?
  - Many endowment agreements provide for distribution of income but no right to encroach on the capital
  - Generally no right to vary the agreement
  - Many endowments provide for hold on expenditure of capital because of pre-budget DQ Rules
- Questions
  - Can capital be encroached?
  - Still need to track 10-year period?
  - Still need to track hold period?

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- Must review documents
  - Existing gift agreements and donors' directions
  - Constating documents –letters patent/special Act/by laws
  - Internal policies relating to spending, distribution of funds, investment policies
  - External publications for fundraising or reporting or other communications
- Must also review regulatory context
  - Federal – Income Tax Act
  - Provincial - Jurisdiction over Charitable property and common law
  - Trust law - common law

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- What to review:
  - Must review terms of gifts
  - What restrictions
    - On investments
    - On expenditure of income or capital
  - For what purpose
  - Timing of expenditure
  - Who imposed the resections
    - Donor
    - Board of charity
  - If can expend income but not capital
    - What does income mean
    - What does capital mean

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- Must identify what type of fund
  - Endowments
  - Restricted funds
  - Unrestricted funds
  - Precatory Gifts – donor advised funds
- If endowments
  - If holding period or other restriction is set by donor at time of gift: trust law considerations
  - If holding period or other restriction set by the Board: may be able to be changed by the board

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- If gift is a trust
  - Trust terms must be complied with and any failure to do so constitutes breach of trust
  - Donor is without authority to vary terms of trust unless power expressly reserved at time trust is settled
  - Thus charity cannot encroach on capital if terms of trust do not permit encroachment

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- **Can agreements be amended?**
  - ***Cypres* court order to vary terms**
    - **If terms impractical or impossible**
    - **Re Killam Estate (1999) 38 ETR (2d)142**
    - **Stillman Case (2003) 68, OR (3d) 777 (SCJ)**
    - **Terms of charitable trusts were varied to permit total return investment policy and capital encroachment based on % of value of the assets**
  - **In Ontario s. 13 *Charities Accounting Act* provides a summary process – PGT involved**

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- **If restrictions in constating documents**
  - **If constating document is a trust (inter vivos or testamentary), check to see whether power to vary and if so the scope of the power and the process for variation**
  - **If constating document is letters patent, follow procedure for amending letters patent in the applicable corporate statute. In Ontario PGT may require that donations received while restrictions in letters patent continue to have those restrictions apply to existing endowments**

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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**

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- 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

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- 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.; more flexible terms
- 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

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6. Corporate Sponsorships

- To receipt or not to receipt?
- No 80% DQ concerns if receipted
- But receipt should not include fmv of marketing/advertising value received by sponsor

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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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- **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**

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- **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**

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8. 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**
    - **Possibly to have large DQ surplus?**
- **What to do with outstanding CRA permission to accumulate property?**
- **What if not meeting its 80% DQ for years being audited?**
- **What if signed compliance agreement to make up DQ shortfall from prior years?**

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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**

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F. CONCLUSION

- **Welcomed change**
- **Simplicity of DQ calculation**
- **Still many unanswered questions**
- **Needs CRA clarification**
- **CRA Fundraising Guidance will be key**

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