OWEN SOUND REGIONAL HOSPITAL FOUNDATION
& COMMUNITY FOUNDATION GREY BRUCE

A WORKSHOP FOR PROFESSIONAL ADVISORS

May 27, 2010

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

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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")**
  - **The sum of**
    - **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")**
  - **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.chairtylaw.ca**

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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

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- 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

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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
    - 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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- 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

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- 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

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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)

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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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D. CRA's ADMINISTRATIVE STEPS

- CRA update April 1, 2010
- CRA released Q&A in April 2010 that resulted in administrative changes in dealing with DQ reform
- 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)

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- Effects of changes to T3010 depends on fiscal year-end
  - If fiscal year ended before March 4, 2010, changes will not affect filed return or return yet to be filed
  - If fiscal year ends on or after March 4, 2010, proposed changes to return apply
    - Charities must continue to use current T3010B, but report in accordance with the insert provided in their T3010B package
    - CRA will continue to release information on the effects of the proposed changes

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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**
- **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?
- 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

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- **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***

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- **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?**

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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**
  - **Maybe remove reference to income and capital**
  - **Use total return investment and payout strategy instead**
- **Length of hold period**
  - **10 years 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.**
- **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 needs to reflect 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
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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**
    - **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?**

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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**

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