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

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. 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
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 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)

• 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
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

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 transeree charity the following year
     – Effect of designating a gift
       • Transferor charity has to meet its own 3.5% DQ with other expenditures

• 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
– 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
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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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
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?

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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