CANADIAN ASSOCIATION OF GIFT PLANNERS

CAGP-ACPDP OTTAWA ROUNDTABLE

Ottawa – January 26, 2011

Endowments - Bird in the Hand or Two in the Bush?

By Karen J. Cooper, LL.B., LL.L., TEP, Carters Professional Corporation
kcooper@carters.ca
1-866-388-9596
and Michelle Osborne, CFRE, University of Toronto

CARTERS UNIVERSITY OF TORONTO

CAGP-ACPDP Ottawa Roundtable
Ottawa – January 26, 2011

Endowments – Bird in the Hand or Two in the Bush?

By Karen J Cooper, LL.B., LL.L., TEP and Michelle M B Osborne, CFRE

CARTERS PROFESSIONAL CORPORATION TOLL FREE: 1-877-942-0001
Ottawa Toronto Mississauga Orangeville
www.carters.ca www.charitylaw.ca www.antiterrorismlaw.ca

2

OVERVIEW

- What is an endowment
- Tradition⬩Current climate
- Pre-2010 federal budget DQ rules
- New DQ rules
- CRA's action
- Implications of new DQ rules

(current as of November 10, 2010)

www.utoronto.ca www.charitylaw.ca

3

What is an Endowment

- NOT a technical term
- Endowment ➢charity's savings account
- Interest supports the charity's activities
- Many charities place bequests into the endowment fund

www.utoronto.ca www.charitylaw.ca

Tradition

- Have been around for centuries
- Set-up for the long-term support of an organization
- Principle preserved, where only the income is made available

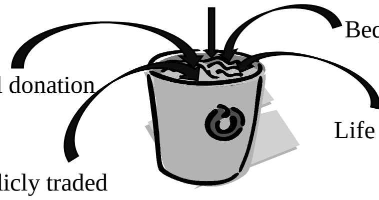
Benefits of an endowment

Charity
- Financial stability of an organization
- Long-range planning
- Recruitment tool

Donor
- Something tangible
- Lasting legacy

Is an endowment for every organization?

- Objectives of your organization
  - Created for short-term need?
  - Does it need every dollar available to meet pressing needs?
  - Longevity



www.carters.ca www.charitylaw.ca

Current climate

- Economy over the past 36 months have challenged concept
- Can or should it spend
- Donors asking about ‘their’ fund
- Disbursement quota

www.utoronto.ca www.charitylaw.ca

9

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

www.utoronto.ca www.charitylaw.ca

2. 80% DQ and 3.5% DQ

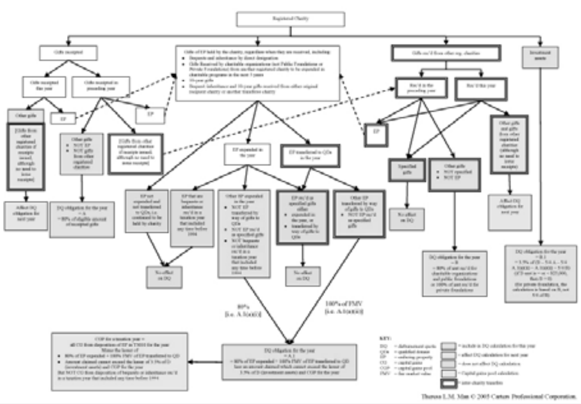
- A charity must spend each year on charitable activities (including gifts to other charities) what is at least equal to 80% DQ + 3.5% DQ
- Failure to meet DQ is grounds for revocation
- 80% DQ (charitable expenditure rule)
  - 80% of gifts receipted in the immediately preceding year (except gifts of enduring property and gifts received from other charities)

- 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)
  - 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

13

Calculation of Disbursement Quota under Bill C-33



14

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

www.utoronto.ca www.charitylaw.ca

15

- 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)
  - Difficult for charities to access capital to comply with DQ obligations

www.utoronto.ca www.charitylaw.ca

- Administrative costs
  - Rigid
  - Confusion whether encroachments to cover administration and investment management fees out of capital of enduring property may taint the enduring property
- Presents inaccurate perception to the public

NEW DQ RULES

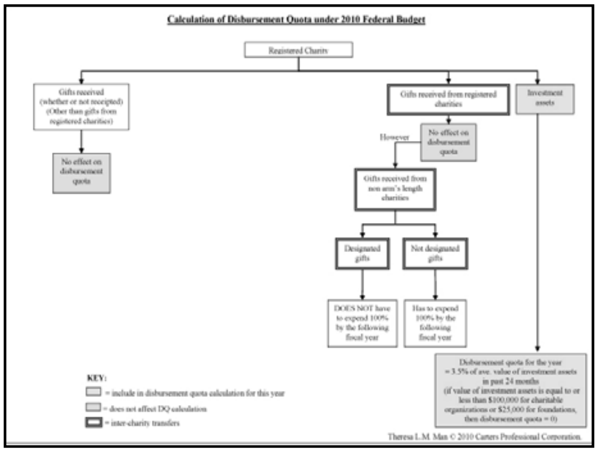
- March 4, 2010 federal budget
- August 27, 2010 draft ITA amendments
- September 28, 2010 Notice of Ways and Means Motions
- Effective for fiscal years that end on or after March 4, 2010
- Finance will monitor effectiveness of CRA's Fundraising Guidance and take further action if necessary

- Repealed 80% DQ
- Repealed 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 (remains at $25,000 for foundations)

- Expanded anti-avoidance provisions
  - ITA now permits revocation of a charity in the case of an inter-charity gift if it can reasonably be considered that one of the main purposes of the transfer was to unduly delay charitable expenditure
  - ITA amended to apply this to “any transaction”, not just inter-charity transfers
  - 110% penalty also possible
  - If inter-charity transfer, both charities are jointly and severally, or solitarily liable for the penalty
  - Both charities risk revocation

- Transfers between non-arm’s length charities
  - Transferee charity must expend the entire amount by the end of the next fiscal year
  - Failure may result in 110% penalty or revocation
  - 100% expenditure is in addition to transferee’s normal 3.5% DQ
  - Exception – if transferor charity elects the gift to be a “designated gift” in its T3010
    - No disbursement requirement on transferee
    - Transferor cannot use the gift to meet its own 3.5% DQ
  - Grey: meaning of “fair market value of the property”

- Accumulation of property
  - Charities can apply to CRA to accumulate property
  - Old rules - property accumulated (and income earned) with CRA approval is deemed to have been spent on charitable activities
  - New rules - accumulated property is excluded from 3.5% DQ asset base calculation
  - Accumulation permitted for particular purposes (such as a building project)



23

CRA's ACTION

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

www.utoronto.ca www.charitylaw.ca

24

- Changes will not affect fiscal year ended before March 4, 2010
- 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 calculation

www.utoronto.ca www.charitylaw.ca

- 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)
- New Form T3010-1 and Guide released on January 18, 2011 for charities with years ending on or after March 2, 2010
- CRA will continue to provide updated information

IMPLICATIONS OF NEW DQ RULES

1. Generally

- No need to disburse 80% of receipted gifts or gifts from arm's length charities
- Only need to comply with 3.5% DQ on investment assets
- Welcomed change
- Simplicity of DQ calculation
- Ease administrative burden for charities (especially small and rural)

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

2. Inter-Charity Transfers

- Transfer between arm's length charities
  - No disbursement requirements on transferee
  - Transferor can use the transfer to meet its 3.5% DQ

- Transfer between non-arm's length charities
  - Transferee must disburse the entire amount by following year, unless a "designated gift"
  - When to "designate" a gift?
    - If gift could not be expended by transferee by the following year
    - Transferor charity has DQ excess
  - Effective of designating a gift?
    - Transferor will have to meet its own 3.5% DQ with other expenditures
    - No disbursement requirement on transferee

3. 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?

- 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

- What to 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

- 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

- 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

4. New Gifts ❖ New World

- 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

5. Special Purpose Funds

- Encroachment
  - Ability to encroach capital? Under what circumstances
- 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

- 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

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

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

- 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

- 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
    - 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?

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
- CRA Fundraising Guidance will be key

CARTERS

UNIVERSITY OF TORONTO

Thank You

Karen J. Cooper, LL.B., LL.L., TEP
Carters Professional Corporation
866-388-9596 x221
kcooper@carters.ca

Michelle M B Osborne, CFRE
Executive Director, Gift Planning
416-978-3811
michelle.osborne@utoronto.ca