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Managing Disbursement Quota Issues During Recessionary Times

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INTRODUCTION

- Economic downturn:
  - lower returns from investments
  - decline in value of capital.
  - charitable programmes at risk
  - inability to meet DQ
- Endowment Funds
  - whether and to what extent charity can encroach on capital to fund commitments and to meet disbursement quota obligations.
  - whether charity can or should change investment strategy

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INTRODUCTION (con't)

- Need to understand
  - what endowment is
  - trust law issues
  - options available under ITA

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What is an Endowment?

- Restricted long term gift
- Capital to be invested and income to be used for charitable purposes
- Capital can be held in perpetuity for a term of years
- Fund can be used for particular purpose or for general purposes of charity

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Types of Endowments

- 10 year gifts
- donor restricted gifts
  - gifts given during lifetime
  - Testamentary gifts
- board restricted gifts
  - board may be able to change use

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10 Year Gifts

- Gifts established in writing by donor pursuant to trust or direction whereby capital and substituted property must be held for period of at least 10 years.
- 10 year gift is a form of enduring property
  - If gift not a 10 year gift charity must expend 80% of gift in following year.
  - Even if avoid 80% spending requirement by 10 year gift, must still expend 3.5% of value of 10 year gift. (separate DQ test)
  - So if income insufficient
    - Look to see if can encroach on capital

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Relevant Considerations

- Starting Point - Terms of the gift
  - ability to expend income/capital
  - is capital to be held for a term of years or in perpetuity?
  - restrictions on types of investments?
  - are restrictions internal or external?
  - trust law issues
  - donor relations

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Is the endowment a trust

- Trusts
  - intention of settlor
  - property or subject matter
  - beneficiaries-objects
- a gift given subject to trust or direction that it is to be held for 10 years
- What is a direction? If it is an obligation to hold property (or property substitute therefor on certain terms – appears to be a trust)
- So even if not called a trust – arrangement will almost invariabley establish a trust – see CRA Dcc # 2008-0031495 where CRA describes enduring property as a trust at law

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If Gift is a Trust

- cannot encroach on capital if terms of trust do not permit encroachment
- charity has no authority to vary terms of a charitable trust unless document creating the endowment permits charity to modify the charitable trust
- variation by court order
- s. 13 Charities Accounting Act (Ontario)
  - Stillman Case
  - total return policy
  - encroachment based on % of value of the assets

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Role of Public Guardian and Trustee

- in Ontario - authority to regulate charities
- must be served if court application
- parens patriae role filled by Attorney General in other provinces

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Internally Restricted Funds

- Board can create a fund to which the donors contribute
- Board can set aside unrestricted funds and make them applicable to a particular purpose
- If wish to amend or vary the terms: What can be done? donor expectations..what were they?
- need to review terms and see whether flexibility may have been built in

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Income Tax Act

- Disbursement Quota (DQ)
- requires that a prescribed amount be disbursed by charity each year
- purpose
  - to ensure that charity's funds are used to further its charitable purposes
  - to discourage charities from accumulating excessive funds
  - keep other expenses at a reasonable level
- With minor differences, the DQ for charitable organizations, public and private foundations is essentially the same

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Computation of DQ

- Two main components
- 80% of prior year's tax receipted gifts other than enduring property and amounts received from other charities
- 3.5% of the average value of the charity's investment property.

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Enduring Property

- gifts of enduring property are generally excluded from the DQ of a charity in the year they are received and included in the year the funds are spent or transferred
- not all types of enduring property are the same or subject to the same restrictions
- bequests, life insurance proceeds, RRSP/RRIF funds are forms of enduring property
- nothing in the ITA requires that there be restrictions on how such funds are to be used by the charity or whether capital/income to be expended
- need to review terms of gift (donor agreement/will) to determine what restrictions there may be
- In contrast 10 year gifts do contain restrictions found in the ITA

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Capital Gains Pool

- a charity can reduce DQ for amounts encroached up to 3.5% of investment assets if it has a capital gains pool
- Capital gains pool: notional account. Total of all capital gains realized from the disposition of enduring property since March 22, 2004 less enduring property gifted and prior permitted encroachments
- capital gains pool can record capital gains not just relating to capital gains realized on 10 year gifts but on capital gains realized on all enduring property

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Why is it relevant

- If charity encroaches on a 10 year gift, it must include 100% (if transferred to another qualified donee) or 80% (if expended on activities) in calculating DQ
- If charity has a capital gains pool it would reduce this amount by the lesser of 3.5% of the value of the investments and the capital gains pool

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EXAMPLE

• Assume only asset of charity is 10 year gift.	$100000
• Interest and dividends on gift (2 percent return)	$2000
• 3.5 % of capital value.	$3500
• Charity wishes to encroach	$3500
• DQ calculation	
• A.1. 80 % of $3500 =	$2800
• B.1 is 3.5 % of $100000 =	3500
• Total DQ is 2800+3500 =	$6300
• Amount available to spend is	$5500
• So have shortfall	
• If had capital gains pool could have reduced DQ	

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Failure to Meet the DQ may result in Revocation of Charity Status

- DQ surplus can be carried forward for 5 years
- So if shortfall - use up earlier years DQ surplus.
- Charity may apply to Minister to reduce DQ (ss. 149.1(5) and Form 2094)
- application will not be considered till after year is over and permission will be granted only if shortfall is result of circumstances beyond the charity's control

(CRA policy commentary: CPC 029)

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CRA Views – Question 1

- On April 22, 2009 CRA released set of questions and answers relating to the treatment of enduring property for purposes of the DQ
- Question 1 deals with how fund agreements define income. For example some fund agreements talk about earnings and don't distinguish between interest, dividends, capital gains.

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CRA Views – Question 1 (con't)

- CRA Response: such gifts may not qualify as enduring property. Realized and unrealized capital gains relating to the original property gifted to the charity or substituted property form part of the gift subject to this holding period.
- Therefore where fund agreements allow the charity to expend these capital gains prior to the end of the 10 year period the gift may not quality as enduring property unless such expenditures do not exceed 3.5%.

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CRA Views – Question 2

- Question 2 concerns encroachments on the capital of a 10 year gift to meet the DQ where the terms of the gift permit encroachment.
- CRA response: a charity is permitted to encroach on the capital of a 10 year gift within the minimum 10 year holding period to the extent of 3.5%. There is nothing in the ITA that says that a charity can only encroach when it cannot meet its DQ and the response did not address this point

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CRA VIEWS – Question 3

- Question 3: if a charity does not track capital gains pools will this inhibit its ability to encroach on capital.
- CRA response: a failure to track capital gains pool does not inhibit a charity's ability to encroach on capital as the rules permit encroachment up to the 3.5% DQ requirement regardless of the capital gains pool balance.
- However where a charity has not kept track of its capital gains pool the charity will be limited in its ability to reduce its DQ requirement. Tracking the capital gains pool allows a charity to reduce its DQ requirement. If a charity does not track its capital gains pool it will be unable to determine the amount of the reduction to which it is entitled.

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CRA VIEWS – Question 4

- Question 4: Does a charity have to track every single 10 year gift to determine when the respective holding periods are over.
- CRA response: Charities are required to track every 10 year gift they receive separately.

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CRA VIEWS – Question 5

- Question 5 and the CRA response clarifies that the fact that a charity has a DQ excess will not preclude it from encroaching on the capital of its 10 year gifts provided it is otherwise permitted to do so by the terms of the gift.

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CRA VIEWS – Question 6

- Question 6 deals with a charity's fund agreements that include the ability to encroach on capital to cover its administration fees and investment management fees.
- CRA response: This may be a concern as such gifts may not qualify as enduring property.
- Amounts spent on administration fees and investment management fees are not charitable expenditures and cannot be used to satisfy the DQ.

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CRA VIEWS – Question 8

- Question 8 addresses the inability of a charity to meet its DQ in 2009 because of the current financial crisis. CRA confirms that where a charity fails to meet its DQ due to unforeseen consequences that are beyond its control it may apply for relief under subsection 149.1(5) of the Act. Relief will only be granted under extraordinary circumstances.
  - See Commentary CPC-029 - Application for DQ relief and
  - See Form 2094

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CREA VIEWS – Question 9

- Question 9 deals with the treatment of an encroachment on the capital of a 10 year gift.
- CRA indicates if the terms of the fund agreement permit the charity to expend a portion of the property gifted in excess of the 3.5%, the gift will not qualify as enduring property and 80% of the gift may be required to be included in DQ in the taxation year subsequent to the year in which the gift was made.

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THANK YOU

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