2011 NATIONAL CHARITY LAW SYMPOSIUM

May 6, 2011

DISBURSEMENT QUOTA REFORM:
THE INS AND OUTS OF WHAT YOU NEED TO KNOW

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A. INTRODUCTION

The disbursement quota is the prescribed amount that registered charities must disburse each year from their assets either on their own charitable programs or on gifts to qualified donees[1] in order to maintain their charitable registration. The purpose of the disbursement quota is to help curtail fundraising costs, to prevent excessive capital accumulation, and to ensure that a significant portion of a registered charity's resources is devoted to further its charitable purposes and activities. A clear understanding of the disbursement quota rules is important for charities in maintaining their charitable status. It is also important for donors and their advisors to have a clear understanding because donors wishing to make donations to a charity will be interested to know the disbursement quota implications of such gifts.

The disbursement quota was first introduced in 1976, and it underwent significant reforms in 1984, 2004 and most recently in 2010. Prior to the 2010 reform, the disbursement quota consisted of, in general terms, an 80% disbursement requirement (also referred to as the "80% disbursement

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[1] Subsection 149.1(1) of the Act provides that qualified donees are organizations that can issue official donation receipts for gifts that individuals and corporations make to them under paragraphs 110.1(1)(a) and (b) and 118.1(1). They consist of registered charities, registered Canadian amateur athletic associations, certain low-cost housing corporations for the aged, municipalities, provincial and federal governments, the United Nations and its agencies, prescribed universities outside Canada, charities outside Canada to which the federal government has made a gift in the past year, and registered national arts service organizations. In February 2004, it was proposed to amend sections 110.1 and 118.1 of the Act by including municipal or public bodies performing a function of government in Canada. This proposed amendment has been brought forth and included in Bill C-33 in November 2006, which died on the Order Paper since the federal Parliament was prorogued on September 14, 2007. The proposed amendment was again re-introduced in Bill C-10 on October 29, 2007. Bill C-10 again died following the dissolution of the federal Parliament on September 7, 2008. Most recently, it was again included in draft legislative proposals released on July 16, 2010.

quota" or "charitable expenditure rule") and a 3.5% disbursement requirement (also referred to as the "3.5% disbursement quota" or "capital accumulation rule"). As a result of the changes brought by the 2004 Federal Budget, the disbursement quota rules had become extremely complicated and difficult to understand and created an unnecessarily onerous administrative burden on charities to comply with the rules. Small and rural charities often found the 80% disbursement quota more difficult to comply with, because they tend to be more dependent on receipted gifts than large charities, which are often more dependent on non-receipted income (such as government grants).

As a result of recommendations from the charitable sector, the complex disbursement rules were significantly simplified by the 2010 Federal Budget ("2010 Budget")[2] by eliminating the 80% disbursement quota and related complicated concepts of enduring property, ten year gift, capital gains pool, and specified gift. The new disbursement quota regime now only requires charities to comply with the 3.5% disbursement quota. The changes introduced by the 2010 Budget were in general well received by the charitable sector. However, uncertainty about its application and implications remains. This paper provides a brief overview of the historical development of the disbursement quota regime in Canada, the efforts that led to the 2010 reform, the changes brought about by the 2010 Budget, and implications of the 2010 changes.

B. HISTORICAL DEVELOPMENT OF THE DISBURSEMENT QUOTA REGIME UP TO 2003

By way of background, in 1950, for the first time, a 90% disbursement requirement was imposed on charitable corporations and charitable trusts to curtail abusive situations involving foundations accumulating funds and distributing the accumulated funds to their "proprietors" without disbursing them on charitable programs.[3]

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[2] Canada, Department of Finance, *Budget* (Ottawa: March 2010) (online: http://www.budget.gc.ca/2010/pdf/budget-planbudgetaire-eng.pdf)..

[3] Ontario Law Reform Commission, *Report of the Law of Charities* (Toronto: Ontario Law Reform Commission, 1996) at 261. See also Can. H. of C. Deb., 18 May 1950, at 2617-21, whereby the Hon. Douglas Charles Abbott. M.P. indicated that the purpose of the amendment was to permit foundations "to set up businesses and claim immunity from taxing statutes, and simply to accumulate funds or accumulate control of corporations or businesses." It was recognized that "there [had] been an opportunity for abuse in the case of these charitable foundations; that is to say, moneys could be accumulated in them and not actually paid over to charities" by accumulating gifts, investment and business income, winding up the foundations and distributing the accumulated funds to their "proprietors."

In 1975, the Department of Finance released a discussion paper, *The Tax Treatment of Charities* (the "1975 Green Paper").[4] After reviewing more than 200 briefs and 30 oral representations in response to the 1975 Green Paper,[5] new changes to the *Income Tax Act* (the "Act") (including new disbursement requirements) were enacted in 1976, effective January 1, 1977.[6] The 1976 Budget Paper released by the Department of Finance indicated that the purposes of the proposed changes were to ensure that "tax-exempt monies flowing to charities are used as intended – as efficiently as possible, and for strictly charitable purposes, not private gain," because "revenue forgone as a result of deductions or exemptions … impose an equivalent extra tax burden on all other taxpayers."[7] Similarly, the 1975 Green Paper indicated that "[e]very dollar of tax relief represents a cost to the Canadian taxpayer," and the "government therefore believes that it is appropriate that the rules of taxation ensure that the people of Canada obtain maximum benefit from the charities."[8]

As part of the 1975 reform, private foundations were required to disburse the greater of 5% of the fair market value of their non-arm's length investments (i.e., non-qualified investments) and 90% of the actual income therefrom.[9] Private foundations were also required to disburse at least 90% of income generated from other sources, e.g., from donations and qualified investments (this did not include capital gains from investments). Both charitable organizations and public foundations were subject to a new 80% disbursement quota requirement, which applied to their previous year's receipted donations, but, in the case of public foundations, it would not include ten-year gifts (i.e., gifts directed by the donor to be held by the charity for at least 10 years). The purpose of the 80%

[4] Canada, Department of Finance, *The Tax Treatment of Charities* (Discussion Paper) (Ottawa: 23 June 1975) (hereinafter referred to as the "1975 Green Paper").
[5] Canada, Department of Finance, *Budget Paper D: Charities under the Income Tax Act* (Ottawa: 25 May 1976) at 2 (hereinafter referred to as the "1976 Budget Paper"). See also Arthur B.C. Drache, Viewpoint "The 1981 Budget: Failure of Process?" [1982] *Philanthropist* (Summer) 43.
[6] S.C. 1976-77, c. 4.
[7] 1976 Budget Paper, *supra* note 5 at 3.
[8] 1975 Green Paper, *supra* note 4 at 5.
[9] This "disbursement quota" applied with a one-year lag time to allow directors to determine the amount required to be disbursed in the following year. The purpose of the amendment was to ensure private foundations earned enough from their non-arm's length investments to meet the 5% disbursement quota requirement and that "charitable activities received some reasonable level of benefit from foundations enjoying tax advantages." This rule did not apply to arm's length investments in the open market (i.e., qualified investments, such as publicly traded securities), capital property used directly in the foundation's own activities or amounts being accumulated for specific projects approved by the Minister of National Revenue. The 5% rule was phased in over three years between 1977 and 1979. See also D. Macdonald, Budget Speech, Can. H. of C. Deb., 25 May 1976, at 13831-32.

rule was to address the issue of increasing fundraising costs in order to ensure that most of the funds received by charities were used in charitable activities.[10]

As a result of further reform proposals from 1981 to 1983,[11] changes were implemented in 1984,[12] whereby public and private foundations were subject to a 4.5% disbursement requirement on their investments; the 90% income disbursement rule was eliminated; all charities were required to disburse 80% of the gifts receipted in the previous year; public foundations were required to disburse 80% (100% for private foundations) of the previous year's receipts from any registered charity in order to prevent related charities with different year ends making grants back and forth without ever having to expend funds on charitable work; as well as ten-year gifts and testamentary gifts were exempted from the disbursement requirements of charitable organizations.[13]

Prior to the next significant disbursement quota reform in 2004, the disbursement quota for charitable organizations, public foundations and private foundations were quite different.[14] These

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[10] The 1975 Green Paper, *supra* note 4 at 11, indicated that high fundraising costs were problematic because (1) it might be used as a "technique to siphon off substantial funds to the organizers of a charity, with a very small benefit accruing to its real purpose"; and (2) it might discourage the public from donating funds to charities "for fear that the money [would] not be employed toward the stated objectives." The 1975 Green Paper originally proposed to amend the Act by deregistering charities if their fundraising costs exceeded 50% of the funds donated in that year. This proposal was not adopted, but the 80% disbursement rule was adopted instead. The 80% rule was phased in over four years between 1977 and 1980.

[11] See Canada, Department of Finance, *Budget* (Ottawa: November 1981), see Resolutions 138 and 139; Canada, Department of Finance, *Press Release* (Ottawa: 21 April 1982); and Canada, Department of Finance, *Charities and the Canadian Tax System A Discussion Paper* (Ottawa: May 1983).

[12] *An Act to amend the Income Tax Act and related statutes*, S.C. 1984, c. 45.

[13] See C.A. Bond, "Implications for Charitable Foundations" in Report of Proceedings of the Thirty-fifth Tax Conference, 1983 (Toronto: Canadian Tax Foundation, 1983) 386; M.L. Dickson and Laurence C. Murray, "Recent Tax Developments" (1984) 4(2) *Philanthropist* 51; and M.L. Dickson and Laurence C. Murray, "Recent Tax Developments" (1985) 5(1) *Philanthropist* 56. See also The Ontario Law Reform Commission Report, *supra* note 3 at 278, indicated that "the fact that charitable organizations and public foundations were required to disburse only a percentage of receipted gifts; the fact that one charity could make a grant from its income to another charity in the form of an endowment (a 'ten-year gift'), turning income in the hands of the first charity into non-disbursable capital in the hands of the second; and the fact that related charities with different year ends could make grants back and forth forever without ever having to expend a cent on charitable work."

[14] For a discussion on the definitions for charitable organizations, public foundations and private foundations, please see Disbursement Quotas: What are they and how to comply", by M.E. Hoffstein and Adam Parachin, presented at the 2nd National Symposium on Charity Law on April 14, 2004.

rules had been criticized for not being equitable or efficient.[15] These rules are summarized as follows:

- All registered charities were required to expend 80% of the previous year's receipted donations on their charitable programs or on gifts to qualified donees. Receipts by charities not subject to the 80% disbursement quota included (1) gifts to charities from donors who did not require donation receipts; (2) receipts by charitable organizations from other charities (this exception did not apply to charitable foundations as indicated below); (3) gifts received subject to a trust or direction that the property given was to be held by the charity for a period of at least 10 years (ten-year gifts); and (4) other revenue receipts, e.g., income from investments, related businesses and fundraising. As well, all registered charities were required to expend 80% of gifts spent by the charity in the year that were previously excluded from the charity's disbursement quota by virtue of being either (i) capital received by way of bequest or inheritance for taxation years that begin after 1993 or (ii) ten-year gifts whenever they were received.

- Public foundations were required to expend 80% of gifts received from other charities, except where the gifts were received as "specified gifts", i.e., where the transferor charity elected in its *Registered Charities Annual Information Return* (T3010) that the gift not be used in meeting its disbursement quota requirements and the recipient charity would not be required to expend 80% of the gift by the following year. For private foundations, they had to expend 100% of gifts received from other charities.

- Charitable foundations (both public and private) were required to disburse 4.5% of their assets not used directly in their charitable activities or administration. The value of the assets was based on the average value of the registered charities' assets not used directly in charitable activities or administration in the 24 months immediately preceding the taxation year.[16] It was expected that a foundation would be "earning a real rate of return on its investments close to or a bit more than 4.5%, and thus the disbursement quota was

[15] James W. Kraft, "Alternatives to the Disbursement Quota of Charities", Discussion Paper (Canadian Association of Gift Planners, 2002) at 5-7.
[16] *Income Tax Regulations* 3700 to 3702 provide a detailed mechanism for the calculation.

calculated so that there was little opportunity for capital growth due to investment earnings over the long term."[17]

C. 2004 DISBURSEMENT QUOTA REFORM

On March 23, 2004 the Department of Finance released the 2004 Federal Budget (the "2004 Budget"), which included significant changes to the disbursement quota. These rules were contained in Bill C-33, which was enacted on May 13, 2005.[18] The 2004 Budget represented a major initiative by the Federal Government since 1984 in rewriting the tax rules concerning the taxation and administration of charities and reflected, to a large extent, the proposals of the Voluntary Sector Initiative's Joint Regulatory Table contained in its report of March 2003 "Strengthening Canada's Charitable Sector: Regulatory Reform".[19] In addition to changes to the disbursement quota rules, other significant changes proposed by the 2004 Budget included new intermediate sanctions, a new internal reconsideration process and the appeal of taxes and penalties to the Tax Court of Canada, transparency and accessibility of information concerning registered charities, etc.

The 2004 Budget brought new changes to the disbursement quota rules resulting in all registered charities being subject to the same disbursement requirements, except one provision for private foundations. To summarize, all charities were subject to an 80% disbursement quota, which was aimed at limiting administrative expenses, and a 3.5% disbursement quota, which was aimed at preventing the accumulation of funds.[20] With these changes, the disbursement quota rules became

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[17] David P. Stevens, "Update on Charity Taxation" in Report of Proceedings of Fifty-Third Tax Conference, 2001 (Toronto: Canadian Tax Foundation, 2002), at 28:38.
[18] The *Budget Implementation Act, 2004, No. 2*, S.C. 2005, c. 19.
[19] Joint Regulatory Table, *Strengthening Canada's Charitable Sector: Regulatory Reform* (Ottawa: Voluntary Sector, March 2003) (online: http://www.vsi-isbc.org/eng/regulations/pdf/final_report_full.pdf).
[20] Under the pre-2010 rules, the formula for disbursement quota set out in section 149.1(1) was A + A1 + B + B1, which essentially means:
A is 80% of receipted donations in the previous year (other than enquiring property or received from other charities);
A.1 is 80% of enduring property expended or transferred to another charity in the year, less encroachment claimed to meet the 3.5% disbursement quota up to what is in the capital gains pool;
B is 80% of amounts received from other charities (100% for private foundations); and
B.1 is 3.5% of assets not used directly in charitable activities or administration, if that amount is greater than $25,000.

much more complicated. As well, a number of difficult concepts and rules were introduced.[21] These new rules applied to registered charities effective as of March 23, 2004, except that the 3.5% disbursement quota did not apply to charitable organizations registered before March 23, 2004, until their taxation years that began after 2008.

One of the most significant changes was the introduction of the concept of "enduring property" into the calculation of the 80% disbursement quota. It included gifts received by way of bequest or inheritance, life insurance proceeds, registered retirement income funds and registered retirement savings plans as a result of direct beneficiary designation, ten-year gifts, and gifts received from a charity to a charitable organization to be expended in its charitable activities within 5 years.[22] As a result, all registered charities were required to meet the 80% disbursement quota, i.e., to disburse at least, generally, (1) 80% of gifts receipted in the immediately preceding year (except gifts of enduring property and gifts received from other registered charities); (2) 80% of enduring property expended in the year and 100% of enduring property transferred to qualified donees in the year, less the optional reduction by the amount of realized capital gains on enduring property; and (3) 80% (but 100% for private foundations) of gifts received from other charities in the immediately preceding year (except gifts received as specified gifts or as enduring property).

As well, charities could track realized capital gains derived from the disposition of enduring property in a notional account called the "capital gains pool." Charities could encroach on enduring property in order to meet its 3.5% disbursement quota, but only up to the amount tracked in the charity's capital gains pool. However, there was much uncertainty involving the treatment of enduring property for disbursement quota purposes, such as tracking of realized capital gains in the capital gains pool, when encroachment was permissible, the difficulty in distinguishing capital and income, etc. On April 20, 2009, CRA released a document entitled "Treatment of Enduring

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[21] For a detailed review of these rules, see M. Elena Hoffstein and Theresa L.M. Man, "New Disbursement Quota Rules under Bill C-33," *The Philanthropist*, Vol. 20, No. 4, pp. 294-332 (online: http://www.thephilanthropist.ca/index.php/phil/article/view/21).

[22] For a detailed explanation on enduring property, see Theresa L.M. Man, "Enduring Property and the Disbursement Quota", *Charity Law Bulletin* No. 171, July 29, 2009 (online: http://www.carters.ca/pub/bulletin/charity/2009/chylb171.pdf).

Property for Purposes of the Disbursement Quota",[23] setting out answers to nine frequently asked questions on this issue.

A number of changes were also implemented in relation to the capital accumulation rule. First, the 4.5% disbursement rate was reduced to 3.5%. The 2004 Budget indicated that the 3.5% disbursement rate was intended to be more representative of historical long-term real rates of return earned on the typical investment portfolio held by a registered charity. The 2004 Budget also indicated that the rate was to be reviewed periodically to ensure that it continued to be representative of long-term rates of return. Second, the application of the 3.5% disbursement quota was extended from charitable foundations to charitable organizations and the exemption from disbursement for inter-charity gifts received by charitable organizations was repealed. The 2004 Budget indicated that the reason for these two changes was because both foundations and charitable organizations may hold capital endowments from which investment income is generated, while historically, only foundations were the primary beneficiaries of endowments. It has been pointed out that this was a major change in tax policy by the Department of Finance that would blur the line between public foundations and charitable organizations to the point that the need for the separate category of public foundations might be eliminated all together, leaving only charitable organizations and private foundations.[24] Third, a *de minimis* threshold was introduced to exempt all charities owning less than $25,000 in investment assets from compliance with the 3.5% disbursement quota, although the threshold was thought by many to be too low and did not provide much relief at all.[25] The value of the assets in calculating the 3.5% disbursement quota is based on

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[23] Canada Revenue Agency, webpage "Treatment of Enduring Property for Purposes of the Disbursement Quota" (online: http://www.cra-arc.gc.ca/chrts-gvng/chrts/plcy/csp/csp-e10-fqs-eng.html).
[24] Hoffstein and Man, *supra* note 21.
[25] For example, when the Department of Finance proposed to apply the same disbursement quota rules to all charities in 1983, it was proposed that charities with investment assets less than $250,000 and did not give more than 25% of their charitable outlays to other charities would be exempt from the 4.5% disbursement quota. Interestingly, the $250,000 threshold proposed in 1983 was ten times the current $25,000 threshold. See 1983 Discussion Paper, *supra* note 11 at 10.

the average value of the charity's assets that are not used directly in its charitable activities or administration in the 24 months immediately preceding the taxation year.[26]

While the reduction of the 4.5% disbursement quota to 3.5% was a welcome change, many other aspects of the rules introduced in 2004 were very complex and were of concern to the sector and their advisors. It was very difficult, if not impossible, for charities to fully understand those rules and to be able to comply with them. A flow chart summarizing the calculation of the disbursement quota is included in Annex I of this paper.[27] This chart was originally prepared to assist charities and their advisors in developing a better understanding of the new rules, but it also illustrates the complexity of these rules.

D. CBA CONCEPT PAPER

As a result of the concerns of the sector to the complicated disbursement quota rules introduced in 2004, the National Charities and Not-for-Profit Law Section of the Canadian Bar Association submitted a *Concept Paper on the Reform of the Disbursement Quota Regime* in July 2009 ("CBA Concept Paper") to the Federal Department of Finance.[28] The CBA Concept Paper indicated that the disbursement quota regime "results in distortions in the gifting decisions of donors to charities and in the expenditure and investment and decision-making of charities."[29] It also indicated that there were "a number of difficult concepts used in the [disbursement quota] regime whose definition for application under the Act is not always clear" and "they exist and present a challenge to explain and apply." Further, it indicated that "the complexity and rigidity of the [disbursement quota] regime also lead to compliance challenges, especially for charities that rely on receipted donations and for small charities that may not enjoy the economies of scale in conducting non-program activities available to larger charities." Main problems of the disbursement quota regime from a policy perspective included the arbitrary concept of enduring property which

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[26] The detailed method for the calculation of the 3.5% disbursement quota is set out in ss. 3700, 3701, and 3702 of the *Income Tax Regulations*, C.R.C. 1978, c. 945 (am. SOR/87-632, s. 1; SOR/94-686, ss. 22(F), 51(F), 73(F), 79(F)). See Theresa L.M. Man, "Calculation of 3.5% Disbursement Quota for All Registered Charities," *Charity Law Bulletin* No. 150, December 18, 2008, for a detailed discussion (online: http://www.carters.ca/pub/bulletin/charity/2008/chylb150.htm).
[27] The chart was attached as a schedule to Hoffstein and Man, *supra* note 21.
[28] Canadian Bar Association, *Concept Paper on the Reform of the Disbursement Quota Regime* to the Federal Department of Finance, July 2009 (online: http://www.cba.org/CBA/submissions/2009eng/09_40.aspx).
[29] Ibid, at 1.

unnecessarily imposed timing restrictions that donors could impose on gifts, disregard of disbursement plans that were different from the time period contemplated under the enduring property concept (i.e., 1 year, 5 years, 10 years), disregard of total return investing by charities and the lack of tax policy rationale to regulate charities' investment strategies, as well as the arbitrary nature of the disbursement quota rules because of the use of an arbitrary fraction (80% and 3.5%), an arbitrary distinction of what were considered to be charitable as opposed to administrative expenses, and an arbitrary 2 year rolling base for calculating the 3.5% disbursement quota.

The CBA Concept Paper set out four specific regulatory objectives pursued by the then current disbursement quota regime: (1) current gifts disbursement; (2) anti-accumulation; (3) efficiency; and (4) fundraising efficiency. It argued that fundraising efficiency is a subset of efficiency objective, and is best pursued by implementing appropriate fundraising guidelines. In this regard, CRA released *Fundraising by Registered Charities* (CPS-028) on June 11, 2009, that regulates the extent and the manner of how a registered charity may utilize its resources on its fundraising activities.[30] With the publication of the said guidance on fundraising and other legislative and administrative initiatives, the 80% disbursement quota became less relevant for curtailing fundraising and other administrative expenses. In relation to the objective of efficiency, this means that registered charities should limit administrative expenses and maximize the amount of resources available for charitable work. It indicated that this objective is better pursued by using donation "markets", i.e., through improved reporting requirements and dissemination of reporting to enhance transparency. As a result, it argued that the disbursement quota regime should only pursue the first and second object, which collectively could be re-stated in one objective, i.e., prevention of undue accumulation of donations, income and capital.

The CBA Concept Paper proposed two options for reform, namely (1) repeal of the 80% disbursement quota and simplify the 3.5% disbursement quota and (2) replace the disbursement quota regime with a different regime that identifies undue accumulations and sanctions them with a penalty tax. These recommendations were supported by Imagine Canada, the Canadian Association of Gift Planners and other organizations in the charitable sector during hearings before the House of Commons Standing Committee on Finance in the fall of 2009.

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[30] *Infra* note 55.

E. 2010 FEDERAL BUDGET DISBURSEMENT QUOTA REFORM

As a result of recommendations from the sector and the CBA Concept Paper, the March 4, 2010 Budget[31] introduced significant reform of the disbursement quota for fiscal years that end on or after March 4, 2010, by repealing the charitable expenditure rule (80% disbursement quota), modifying the capital accumulation rule (3.5% disbursement quota) and introducing related anti-avoidance rules.[32] These new changes are contained in Bill C-47, which was enacted by Parliament and received Royal Assent on December 15, 2010.[33]

The 2010 Budget indicated that one of the reasons that led to the changes was the requests from stakeholders for the elimination of the disbursement quota because it imposed an unduly complex and costly administrative burden on charities - particularly small and rural charities and it constrained the flexibility of charities, without achieving its core purpose of limiting spending on fundraising and non-charitable activities. In this regard, the 2010 Budget acknowledged that the impact of the charitable expenditure rule can vary considerably, for reasons unrelated to the manner in which a charity conducts its charitable activities. In particular, charities that receive government grants and related business revenues would have less difficulty in meeting the charitable expenditure rule even if they do not spend their tax-receipted donations on charitable activities, because all charitable expenditures count toward meeting the disbursement quota. In contrast, the rule is much more constraining on small and rural charities that rely mainly on tax-receipted donations.

In addition, the 2010 Budget recognized that recent legislative and administrative initiatives have strengthened CRA's ability to ensure that a charity's fundraising and other practices are appropriate,

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[31] *Supra* note 2.
[32] For an overview of these changes, see Karen J. Cooper and Terrance S. Carter, "Significant Benefit for Charities in 2010 Federal Budget DQ Reform", *Charity Law Bulletin* No. 197, March 8, 2010 (online: http://www.carters.ca/pub/bulletin/charity/2010/chylb197.pdf); Donald Bourgeois, "Eliminating the Disbursement Quota: Gold or Fool's Gold?", 23(2) *The Philanthropist* (thephilanthropist.ca) 184-89 (2010) (online: http://www.thephilanthropist.ca/index.php/phil/article/view/825) ; Adam Aptowitzer, "Ghost of Disbursement Quotas Past", 18(4) *Cdn Not-for-Profit News* (Carswell) 25-27 (April 2010) and xxxii(6); Arthur Drache, "Charities Mulling Disbursement Quota Changes", 18(5) CNfPN 33-35 (May 2010); Daniel Frajman, "Foundations and Disbursement Quota Reform", xxxii(16) The Canadian Taxpayer 123-25 (Aug. 10/10); M. Elena Hoffstein, "Amendments to the Disbursement Quota Regime in Canada's Federal Budget 2010", *STEP Journal*, September 2010, Volume 18 (online: http://stepjournal.org/journal_archive/2010/step_journal_september_2010/great_benefit.aspx); Arthur Drache, "Disbursement Quota Changes a Two-Edged Sword", 18(12) *Cdn Not-for-Profit News* 89-90 (Dec. 2010), .
[33] The *Budget Implementation Act, 2010, No. 2,* S.C. 2010, c. 25.

such as CRA's guidance on fundraising.[34] As well, CRA may impose sanctions or revoke the registration of a charity in situations where charities use their funds inappropriately, such as in cases where there is undue private benefit. The Department of Finance recognized that these tools provide a more effective and direct means to fulfill the objectives of the charitable expenditure rule of the disbursement quota. As such, the 2010 Budget indicated that the Government will monitor the effectiveness of CRA's guidance on fundraising and take action if needed to ensure its stated objectives are achieved.

Specifically, the amendments brought by the 2010 Budget are as follows:

1. <u>Repeal of capital expenditure rule and related concepts</u>

One of the key changes introduced by the 2010 Budget was the repeal of the charitable expenditure rule. Charities are no longer required to expend 80% of their receipted revenue in meeting their disbursement quota. As such, charities are only required to meet the 3.5% disbursement quota. In this regard, the definition for "disbursement quota" was amended by removing the 80% disbursement rule.[35]

As a result of repealing the 80% disbursement quota, complicated concepts that were introduced in 2004 are also repealed and are no longer required to calculate the disbursement quota. These concepts include enduring property, capital gains pool, capital gains reduction and specified gifts. Accordingly, the definitions for "capital gains pools," "enduring property" and "specified gift" in subsection 149.91(1) were repealed.

2. <u>Modification of the capital accumulation rule</u>

Before the 2010 Budget, there was an exemption from the 3.5% disbursement quota for charities having $25,000 or less in assets not used in charitable programs or administration. The 2010

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[34] *Infra* note 55.
[35] Subsection 149.1(1) of the Act. The disbursement quota formula was changed to A + B x 0.035/365, where
A is the number of days in the taxation year, and
B is is 3.5% of assets not used directly in charitable activities or administration, if that amount is greater than $100,000 for a charitable organization and $25,000 for a foundation.

Budget increased this threshold to $100,000 for charitable organizations, but the threshold remains at $25,000 for charitable foundations. The 2010 Budget indicated that the purpose of increasing the threshold for charitable organizations is to reduce the compliance burden on small charitable organizations and provide them with greater ability to maintain reserves to deal with contingencies. In this regard, the definition for "disbursement quota" in subsection 149.1(1) was amended by simplifying the calculation for the 3.5% disbursement quota and revising the applicable thresholds.[36]

The amount of all assets not currently used in charitable programs or administration, for the purpose of the capital accumulation rule in the disbursement quota, is subject to the calculation provided for in the *Income Tax Regulations*. This calculation required a technical amendment to subsection 149.1(1.2) of the Act and Regulations 3700, 3701 and 3701 to clarify that it applies both to charitable foundations and charitable organizations.

3. <u>Expansion of anti-avoidance rules</u>

In relaxing the disbursement requirements, the 2010 Budget indicated that previously existing anti-avoidance rules had to be extended to situations where it could reasonably be considered that a purpose of a transaction was to delay unduly or avoid the application of the disbursement quota. In this regard, two key changes were introduced to the Act. Shortly after the announcement of the 2010 Budget, CRA created a new webpage on March 14, 2011, entitled "new anti-avoidance rules and designated gifts" in relation to these new rules.[37]

a) Non-arm's length inter-charity gifts

The 2010 Budget introduced a new provision to ensure that amounts transferred between non-arm's length charities will be used to satisfy the disbursement quota of only one charity. In this regard the recipient charity will be required to spend the full value of the property it received from a non-arm's length charity on the recipient charity's own charitable activities or to transfer the

[36] The disbursement quota formula was changed from A + A1 + B + B1 to A +B x 0.035/365, for taxation years ending after March 3, 2010

[37] Canada Revenue Agency, webpage "New anti-avoidance rules and designated gifts" (online: http://www.cra-arc.gc.ca/chrts-gvng/chrts/prtng/gfts/nt-vdnc-eng.html).

amount to one or more arm's length qualified donees in the current or subsequent taxation year. This is also referred to as the "immediate disbursement requirement" in the 2010 Budget. This new disbursement is an additional requirement outside of the 3.5% disbursement quota for the recipient charity.

Alternatively, the transferor charity may elect in its *Registered Charities Annual Information Return* (T3010) that the gift or a portion of the gift transferred be recognized as a "designated gift." The effect of the designation is that the amount so designated would not be counted towards satisfying the transferor charity's disbursement quota obligations, and the recipient charity would not be subject to the immediate disbursement requirement.

Specifically, a new definition for "designated gift" was inserted in subsection 149.1(1) to refer to that portion of a gift between two non-arm's length registered charities that is designated by the transferor charity in its T3010. Paragraph 149.1(1.1)(a) of the Act was amended such that a designated gift is deemed not to be an expenditure on charitable activities or a gift to a qualified donee, and thereby would not be included in meeting the recipient's disbursement quota requirements under paragraphs 149.1(2)(b), (3)(b) and (4)(b). As well, a designated gift would also not be included for purposes of determining the disbursement excess under subsection 149.1(21) or the recipient's income under subparagraph 149.1(12)(b)(i).

If the transferor charity did not elect the gift as a designated gift and the recipient charity did not comply with this new immediate disbursement requirement (i.e., where the recipient charity expended "an amount that is less than the fair market value of the property"), the recipient charity could be subject to a penalty of 110% of the difference between the fair market value of the property and the amount expended by the recipient charity pursuant to a new subsection 188.1(12) of the Act. For example, if the recipient charity only expended 40% of the value of such a gift, then it would be subject to a 110% penalty of 60% of the value of the gift. In addition, the recipient charity may also be subject to revocation by CRA pursuant to new paragraph 149.1(4.1)(d) of the Act.

b) Transactions to avoid or unduly delay charitable expenditure

The anti-avoidance provisions in paragraphs 149.1(4.1)(a) and (b) were also expanded to sanction a registered charity that has entered into a transaction (which may include an inter-charity gift) where it "may reasonably be considered that a purpose of the transaction was to avoid or unduly delay the expenditure of amounts on charitable activities."

Paragraphs 149.1(4.1)(a) and (b) previously permitted revocation of a transferor charity that had made an inter-charity gift if it "can reasonably be considered that one of the main purposes of making the gift was to unduly delay" its charitable expenditure, and revocation of the recipient charity, as well if it "can reasonably be considered that" its acceptance of the gift was an act "in concert with" the transferor charity. These provisions were considerably expanded by the 2010 Budget in a number of respects:

- The application of these provisions is no longer limited to situations involving inter-charity gifts, but any "transaction" that may or may not involve an inter-charity gift. As well, the "transaction" may or may not involve another charity, e.g., it may be something that is done by one charity on its own or with another entity that is not a charity.

- The previous provisions were only applicable to inter-charity gifts where "it *can* reasonably be considered that *one of the main purposes*" of the gift was to "unduly delay" charitable expenditure. The new provisions are expanded to apply to any transaction as long as "it *may* reasonably be considered that *a purpose* of the transaction was to avoid or unduly delay" charitable expenditure. As such, the threshold for the application of these provisions has been made much lower. It is no longer necessary that one of the main proposes of an inter-charity gift is to avoid compliance with the charitable disbursement quota requirements, but, instead, a transaction could be caught off side as long as one of its purposes, minor as it may be, is to avoid compliance.

- The requirement that the inter-charity gift was to "unduly delay" charitable expenditure was expanded to transactions that are intended to "avoid or unduly delay" charitable expenditure.

- Where another registered charity is involved, the application of these provisions is also expanded. Previously, the provision applied to situations where this other charity “acted in concert with” the transferor charity by virtue of the recipient charity’s accepting the gift. Under the new provisions, the other charity that is involved in the transaction would also be subject to revocation if a purpose of its involvement in the transaction is “to assist” the first charity.

- It is also important to note that where a transaction involves an inter-charity gift, these provisions apply regardless of whether or not the recipient charity is at arm’s length to the transferor charity.

Subsection 188.1(11) previously provided that registered charities that did not comply with the avoidance provisions were subject to a penalty of 110% of the inter-charity gift and that both charities were jointly and severally, or solidarily, liable to the penalty. Subsection 188.1(11) was amended by the 2010 Budget to apply to the charities referred to in the amended paragraphs 149.1(4.1)(a) and (b) to a 110% penalty of the charitable expenditure so avoided or delayed. In the case of an inter-charity gift, both charities will continue to be jointly and severally, or solidarily, liable to the penalty.

4. <u>Amendment of rules regarding accumulation of property</u>

As a result of repealing the 80% disbursement quota, it was also necessary to amend the existing rules that provide CRA with the discretion to allow charities to accumulate property for a particular purpose, such as a building project. The previous subsection 149.1(8) provided that property accumulated (including income earned in respect of that property) with CRA’s approval was deemed to have been spent on charitable activities in the year the property was accumulated and included in meeting the charity’s 80% disbursement quota for that year. When the accumulated property was subsequently expended, it would not be included in meeting the charity’s 80% disbursement quota in the year of expenditure. The previous subsection 149.1(9) further provided that if property so accumulated was not used for the purpose for which approval was granted at the end of the accumulation period approved by CRA or was decided by the charity not to be used for the intended purpose, then the property so accumulated would be deemed to be gifts received in that year and included in calculating the charity's 80% disbursement quota for that year. With the repeal of the 80% disbursement quota, the mechanism to take into account accumulated property had to be revised.

Under the 2010 Budget, subsection 149.1(8) was amended and subsection 149.1(9) was repealed so that CRA will have the discretion to permit the exclusion of property accumulated (including interest earned) from the asset base in calculating the 3.5% disbursement quota. However, if the charity is not in compliance with the terms and conditions imposed by CRA when approval to accumulate property was granted, the charity will not be permitted to exclude the property from the asset base.

F. CANADA REVENUE AGENCY'S RESPONSE

Soon after the announcement of the 2010 Budget on March 4, 2010, CRA posted a message from the Director General of the Charities Directorate on March 31, 2010, advising that it would revise the Registered Charity Information Return T3010B, but in the short term, CRA would include instructions with the T3010B return packages that would be mailed to charities starting in April 2010. The said T3010B instruction sheet was released by CRA on April 27, 2010, providing detailed line-by-line instruction on how to complete the T3010B for charities with a fiscal period ending on or after March 4, 2010, in light of the new disbursement quota rules. On January 18, 2011, a newly revised Form T3010-1 and Guide T4033-1 were released by CRA to be used for fiscal periods ending on or after March 4, 2010 (while charities are to continue to use T3010B for fiscal periods ending from January 1, 2009, to March 3, 2010).

On May 3, 2010, CRA released a list of 15 questions and answers in relation to the new disbursement quota rules.[38] For those who do not want to read a technical document, such as the 2010 Budget, CRA's questions and answers provide a friendly version of the new disbursement quota rules in layman terms. On May 4, 2010, a new CRA webpage[39] was launched and dedicated to providing updated information on the impact of the 2010 Budget. CRA also indicated in

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[38] Canada Revenue Agency, webpage "Charities: Disbursement quota reform" (online: http://www.cra-arc.gc.ca/gncy/bdgt/2010/chrt-eng.html).

[39] Canada Revenue Canada, webpage "Budget 2010 - Changes for charities" (online: http://www.cra-arc.gc.ca/chrts-gvng/chrts/bdgt2010/menu-eng.html).

question 13 of the list of 15 questions referred to above that it will develop further guidance to assist registered charities in understanding and complying with the reformed disbursement quota and other income tax rules concerning expenditures. It also indicated that this development will include consultation with the charitable sector.

G. IMPLICATIONS OF 2010 NEW DISBURSEMENT QUOTA RULES

The 2010 Budget introduced many welcomed changes to the disbursement quota. However, a number of the implications of these changes are of concern to the charitable sector. The following is a review of the key implications.

1. Simplicity

One of the welcomed changes brought by the 2010 Budget is the simplicity of the new disbursement quota rules. With the repeal of the 80% disbursement quota and related complicated concepts, the new disbursement quota has become much simpler. A flow chart summarizing the calculation of the new disbursement quota rules introduced by the 2010 Budget is set out in Annex II of this paper. As can be seen from this chart, in comparison with the chart set out in Annex I representing the disbursement quota prior to the 2010 Budget, the simplicity of the disbursement quota resulting from the 2010 Budget is obvious.

Other welcomed ramifications brought by the new rules include:

- lighter administrative burden for charities (especially small and rural charities) to comply with the disbursement quota requirements;

- greater ability for charitable organizations to maintain reserves to deal with contingencies as a result of the increase of the *de minimis* threshold for the application of the 3.5% disbursement quota;

- no need to track receipted and non-receipted gifts for disbursement quota purposes;

- no need to track 10-year expiration for 10-year gifts; and

- greater freedom for charities to structure endowments and long term gifts with donors and increased ability to focus their efforts on balancing donor desires for long-term financial stability with the need for flexibility to meet changing economic conditions.

2. Non-arm's length inter-charity gifts

As a result of the introduction of the immediate disbursement requirement requiring a charity that received a gift from a non-arm's length charity to disburse the full value of the gift by the end of the following year, transfers between non-arm's length charities will need to be carefully structured in order to avoid unexpected application of the immediate disbursement requirement.

Where there is a transfer between two non-arm's length charities, the charities will need to consider whether the recipient charity intends, or is even able, to expend the full amount of the gift by the end of the following fiscal year. If not, then the only option to avoid the immediate disbursement requirement is to have the transferor charity elect that the gift is a designated gift under the Act. In doing so, the transferor charity will not be able to utilize the designated gift to satisfy its disbursement quota obligation in the year of the transfer and therefore the transferor charity will have to ensure that it has sufficient other charitable expenditure to meet its own 3.5% disbursement quota. The transferor charity will have to ensure that the election is made in its T3010-1 for the year when the gift is made. CRA recommended that if the transferor does not intend to designate the gift, the transferor charity should "inform the recipient charity that a gift is [not] a designated gift to allow the recipient charity to adequately track its own spending requirement for the fiscal period."[40] In this regard, it would also be prudent for the two charities to ensure that the transfer of the designated gift is properly documented. CRA does not prescribe what evidentiary document to use. Examples could include a brief memorandum of understanding, gift agreement or confirming correspondence.

It is not necessary for the entire gift to be designated and, as such, the transferor charity is free to designate only a portion of a gift. In a recent CRA technical interpretation,[41] CRA was asked to

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[40] Canada Revenue Agency, webpage "New anti-avoidance rules and designated gifts" (online: http://www.cra-arc.gc.ca/chrts-gvng/chrts/prtng/gfts/nt-vdnc-eng.html).
[41] Canada Revenue Agency Document 2010-0370841E5, September 24, 2010.

comment on two hypothetical scenarios concerning the application of the designated gift designation. In the first scenario, a registered charity plans to gift real property that is used in its charitable activities to another registered charity that is a related charitable foundation. The value of the real property is $10 million. The transferor charity will otherwise be able to meet its disbursement quota for the year and the full value of the real property will be designated as a designated gift. CRA confirmed that the transferor charity will be precluded from using the designated gift to satisfy its disbursement quota, and the recipient charity will not be subject to the immediate disbursement requirement in respect of the designated gift. The second scenario involves the same facts, except that the transferor charity will have a deficiency of $100,000 in its disbursement obligation without taking into account the gift of real property. The transferor charity intends to use $100,000 of the value of the gifted property to meet its disbursement quota and designate the remaining value of $9,900,000 as a designated gift. CRA confirmed that the transferor charity will be able to use the $100,000 to meet its own disbursement quota, and the recipient charity will have to expend $100,000 by its following fiscal year. However, the remaining gift of $9,900,000 to the recipient charity will not be subject to the immediate disbursement requirement.

However, there are a number of concerns regarding this new immediate disbursement requirement. For example:

- The recipient charity is required to expend "an amount that is [not] less than the fair market value of the property." CRA indicates on their webpage that the fair market value of the property is to be determined at the time when the property was gifted.[42] A problem may arise in situations where the value of the property was to decrease after it has been gifted. In this case, the transferor charity would be able to claim the value of the property at the time of the gift in meeting its 3.5% disbursement quota. However, the recipient charity would have a problem to expend by the end of the following fiscal year the full value of the property at the time of the gift, since the value of the property at the end of the following fiscal year would be less than the value when it was gifted. Clarity on this issue is important in order that charities may be able to accurately determine the extent of the immediate disbursement requirement obligations and be able to determine whether a gift should be designated.

- Another concern is that the term "designated gift" may potentially lead to misunderstanding in the charitable sector, because this term is commonly used by the sector in other contexts. For example, when a transfer is made from a hospital foundation to a hospital, the foundation may "designate" that the funds be used for a particular purpose, e.g., to acquire a particular piece of equipment for the hospital. As such, the sector may not understand that the designation required for purposes of avoiding the immediate disbursement requirement obligations is different from their day-to-day usage of this term. It would have been preferable that another more appropriate term be used that is not otherwise commonly used in the sector, e.g., exempted gift, elected gift, etc.

- The immediate disbursement requirement will have the unintended result of preventing the transfer of endowments between non-arm's length charities, such as from a hospital to a parallel hospital foundation. A hospital foundation, in raising funds and transferring them to the hospital, meets the foundation's charitable purposes. The subsequent expenditure of the gift by the hospital would also meet the hospital's charitable purposes. As such, there does not appear to be any tax policy reasons to require the hospital to expend the gift from its parallel foundation by the following year, or to require the hospital foundation to designate the transfer as a designated gift in order to allow the hospital flexibility in when it must expend the gift.

- The transfer of endowment funds from an operating charity to a parallel foundation or asset holding charity for asset protection purposes will also be affected by the immediate disbursement requirement. For example, if an operating charity was to transfer $20 million in endowment funds to a newly established parallel foundation for asset protection purposes, the parallel foundation will be required under the immediate disbursement requirement to expend the entire $20 million by the following year, which would defeat the purpose of the transfer or even the establishment of the foundation in the first place.

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[42] Canada Revenue Agency, webpage "New anti-avoidance rules and designated gifts" (online: http://www.cra-arc.gc.ca/chrts-gvng/chrts/prtng/gfts/nt-vdnc-eng.html

Otherwise, the operating charity will have to designate the $20 million as a designated gift, and it will have to ensure that it has sufficient other charitable expenditures to meet its own 3.5% disbursement quota. Again, there does not appear to be any tax policy reasons to prevent such type of inter-charity transfer.

- There also does not appear to be any tax policy rationale for the immediate disbursement requirement at all. If the transfer of a gift to an arm's length charity is not of concern, it is difficult to understand why the transfer to a non-arm's length charity (such as a parallel foundation) would justify the drastic requirement that the capital of the entire gift be expended, as opposed to 3.5% of it. It may be more appropriate to require 3.5% of the gift be expended by either the transferor charity or by the recipient charity or jointly by them in the same year when the gift was made, together with preventing the transferor charity from using the $20 million in meeting its own disbursement quota in the year.

- The application of the arm's length concept to non-share capital organizations in the charitable sector is not clear. Subsection 251 of the Act provides a set of rules that determine what arm's length means. However, jurisprudence and CRA's administrative policy on the issue of whether two entities are at arm's length are mostly in the share capital context.[43] A clear understanding of this concept as it applies to the non-share capital charitable sector is important to ensure that charities would not inadvertently violate the immediate disbursement requirement provision in the Act.[44] In a recent CRA technical interpretation,[45] CRA was asked to comment whether a non-profit organization and a registered charity deal at arm's length with each other where only members of the non-profit organization would qualify to become directors of the charity. CRA indicated that it is a question of fact whether two entities are dealing at arm's length, except where paragraph 25(1)(a) or (b) of the Act applies. Factors to be considered include whether there is a common mind which directs the bargaining for both parties to a transaction; whether

[43] Canada Revenue Agency, Interpretation Bulletin IT-419R2, "Meaning of Arm's Length" (8 June 2004) (http://www.cra-arc.gc.ca/E/pub/tp/it419r2/README.html).
[44] See Karen J. Cooper, "Control: Who, How, What, When and Why?" paper presented at the 4th National Symposium on Charity Law held in Toronto by the Canadian Bar Association and the Ontario Bar Association, May 11, 2006, (online: http://www.carters.ca/pub/article/charity/2006/kjc0511.pdf).
[45] Canada Revenue Agency Document 2010-0373181C6, October 8, 2010.

the parties to a transaction are acting in concert without separate interests; and whether there is a "de facto" control. More information is set out in CRA's Interpretation Bulletin IT-419R2.[46] When analyzing the facts and circumstances surrounding a particular situation, CRA would also take into account jurisprudence. For example, CRA indicated that having the same directors in two corporations, as well as employees working for both corporations are relevant factors.[47]

- Lastly, CRA's website[48] indicates that charities that need to report a designated gift can use Form T1236, Qualified Donees Worksheet / Amounts Provided to Other Organizations. In this regard, on the blank line below the BN/Registration number of the recipient charity, the transferor charity is to indicate whether a gift is a designated gift and the amount of the gift that is designated. However, it would be clearer if, instead of providing a blank line for the charity to insert this information, the form be revised to clearly indicate where the charity is to indicate if the gift is a designated gift and where to insert the amount of the gift in another clearly marked space on the form.

3. Avoidance transactions

As indicated above, the anti-avoidance provisions in paragraphs 149.1(4.1)(a) and (b) were expanded to include situations where a registered charity may be subject to revocation if it entered into a transaction (which may include an inter-charity gift) where it "may reasonably be considered that a purpose of the transaction was to avoid or unduly delay the expenditure of amounts on charitable activities."

Paragraphs 149.1(4.1)(a) and (b) previously permitted revocation of a transferor charity that has made an inter-charity gift if it "can reasonably be considered that one of the main purposes of making the gift was to unduly delay" its charitable expenditure, and revocation of the recipient

46 *Supra* note 43.
47 *Noranda Mines Limited v. M.R.N.*, [1987] 2 C.T.C. 2089, 87 D.T.C. 379 (TCC). See also Barbara Wallace, "Inter-Charity Gifts Policy", *Canadian Council of Christian Charities Bulletin*, Issue 2, March 2011.
48 Canada Revenue Agency, webpage "New anti-avoidance rules and designated gifts" (online: http://www.cra-arc.gc.ca/chrts-gvng/chrts/prtng/gfts/nt-vdnc-eng.html).

charity as well if it "can reasonably be considered that" its acceptance of the gift was an act "in concert with" the transferor charity.

There are a number of concerns regarding these expanded anti-avoidance provisions. For example:

- The meaning of the term "transaction" is very broad, and therefore its meaning for purposes of paragraphs 149.1(4.1)(a) and (b) is not entirely clear. As well, the meaning for the term "avoid or unduly delay" is vague. No guidance has been provided in the 2010 Budget paper or by CRA in relation to the meaning and application of these terms. Presumably, these provisions might be interpreted to preclude a donor making an endowed gift, where the charity is required to hold the capital in perpetuity. Clearly, these provisions are not intended to prevent donors from making endowed or long term gifts to charities, but the vague wording of the provision still leaves a concern in this regard. Another grey area is where a charity transfers an endowment fund to an arm's length charity. Since the two charities are at arm's length, such a transfer would not run afoul of the non-arm's length inter-charity gift referred to above. However, since the endowed gift is intended to require the recipient charity to hold the fund in perpetuity or for a long period of time, it is not entirely clear whether such a transaction would be recognized to avoid or unduly delay charitable expenditure and therefore be prohibited. In a recent CRA technical interpretation,[49] CRA indicated that whether any purpose of a transaction is to avoid or unduly delay the expenditure of amounts on charitable activities is a question of fact and must be determined on a case-by-case basis.

- As indicated above, the threshold of the application of the anti-avoidance provisions has been lowered so that it is no longer necessary that one of the *main* proposes of an inter-charity gift was to avoid compliance with the charitable disbursement quota requirements, but it would apply to any transaction as long as one of its purposes, minor as it may be, was to avoid compliance. This is concerning because it would require charities to carefully examine every aspect of every "transaction" that it enters into in order to ensure

[49] *Supra* note 41.

that there is no unintended collateral consequence that may lead to an argument being made that the unintended consequence was one of the purposes for entering into the transaction.

- This provision applies to inter-charity gifts, regardless of whether the recipient charity is at arm's length to the transferor charity, but there is no carve out for situations involving designated gifts in the case of non-arm's length transfers. It is not reasonable for the provisions to apply in situations where the gift made is a designated gift.

- On CRA's webpage entitled "new anti-avoidance rules and designated gifts,"[50] charities are only warned of inter-charity transfers between non-arm's length charities, but not avoidance transactions described above.

4. Charitable expenditures

Even though the 80% disbursement quota is repealed, registered charities are still required to devote all of their resources to charitable activities or to further their charitable purposes. CRA clarified in its list of 15 questions and answers released on May 3, 2010, in relation to the new disbursement quota rules, as follows.[51]

> 12. Does this mean that registered charities can spend their money however they want?
> No. Registered charities have always had to devote their resources to charitable programs to maintain their charitable registration, and this is still the case. The disbursement quota requirement is just one part of the rule. Recent legislative and administrative initiatives have strengthened the CRA's ability to ensure that charities are spending their money on charitable programs, and have helped charities understand which expenditures are appropriate. For example, the CRA recently published Fundraising by Registered Charities, which provides guidance to charities on what are acceptable fundraising expenditures.

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[50] Canada Revenue Agency, webpage "new anti-avoidance rules and designated gifts" (online: http://www.cra-arc.gc.ca/chrts-gvng/chrts/prtng/gfts/nt-vdnc-eng.html).
[51] *Supra* note 38.

Charitable organizations are required under the Act to devote all of their resources to charitable activities or as gifts to qualified donees.[52] Charitable foundations are also required to devote their resources to their charitable purposes.[53] While the repeal of the 80% disbursement quota has made the calculation of the disbursement quota formula much simpler, the concern is that charities are left to comply with the general requirement that charities must devote all of their resources to their charitable activities, with no objective standard to measure compliance.[54] This would leave charities to face uncertainty about how this requirement would be enforced by CRA.

5. <u>CRA's fundraising guidance</u>

The 2010 Budget indicated that one of the reasons for the repeal of the 80% disbursement quota was the recent legislative and administrative initiatives that have strengthened CRA's ability to ensure that a charity's fundraising and other practices are appropriate. In particular, CRA released its *Fundraising by Registered Charities* (CPS-028) on June 11, 2009, ("Fundraising Guidance") to regulate the extent and the manner of how a registered charity may utilize its resources on its fundraising activities.[55] The 2010 Budget indicated that the Government will continue to monitor the effectiveness of the Fundraising Guidance and take action if needed to ensure its stated objectives are achieved. This also noted in question 13 of CRA's list of 15 questions and answers in relation to the new disbursement quota rules released on May 3, 2010.[56]

CRA indicated that the Fundraising Guidance is intended to outline policies and practices that CRA uses when it reviews annual information returns filed by registered charities and explains

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[52] See definition for "charitable organization" in paragraph 149.1(1)(a) and subsection 149.1(6)of the Act. Subsection 149.1(10) of the Act states, "An amount paid by a charitable organization to a qualified donee that is not paid out of the income of the charitable organization shall be deemed to be a devotion of a resource of the charitable organization to a charitable activity carried on by it."
[53] See definition for "charitable foundation" in subsections 149.1(1) and 149.1(6.1) of the Act.
[54] Drache, A "Disbursement Quota Changes a Two-Edged Sword", 18(12) *Cdn Not-for-Profit News* 89-90 (Dec. 2010) Adam Aptowitzer, "Ghost of Disbursement Quotas Past", 18(4) *Cdn Not-for-Profit News* (Carswell) 25-27 (April 2010) and xxxii(6); and Donald Bourgeois, "Eliminating the Disbursement Quota: Gold or Fool's Gold?", 23(2) *The Philanthropist* (thephilanthropist.ca) 184-89 (2010).
[55] Canada Revenue Agency, *Policy Statement CPS-028, Guidance on Fundraising by Registered Charities* (11 June 2009) (online: http://www.cra-arc.gc.ca/tx/chrts/plcy/cps/cps-028-eng.html) and Canada Revenue Agency, *Additional information on Guidance CPS-028, Fundraising by Registered Charities* (11 June 2009) (online: http://www.cra-arc.gc.ca/tx/chrts/plcy/cps/cps-028-ddn-eng.html).
[56] *Supra* note 38.

CRA's views on issues relevant to fundraising expenditures.[57] The Fundraising Guidance sets out a number of prohibited conducts relating to fundraising that charities may not engage in; how charities may report fundraising expenses in their T3010; best practices that may decrease the risk of unacceptable fundraising; indicators that could cause the CRA to further review a registered charity's fundraising activities; and fundraising ratio guidelines. The fundraising ratio is the ratio of fundraising costs spent in a fiscal year in comparison with fundraising revenue received in the fiscal year. In general, if the fundraising ratio is under 35%, it is unlikely to generate questions or concerns from CRA; if the ratio is 35% or above, CRA will examine the average ratio over a number of years to determine if there is a trend of high fundraising costs and if there is a need for a more detailed assessment of expenditures; and if the ratio is above 70%, this will raise concerns with CRA and the charity must be able to provide an explanation and rationale for this level of expenditure to show that it is in compliance with the Fundraising Guidance.

With the repeal of the 80% disbursement quota, it is therefore anticipated that much emphasis will be put on compliance with the Fundraising Guidance by charities. Charities will need to familiarize themselves with the Fundraising Guidance and to ensure compliance with the same. However, with the increasing importance of the Fundraising Guidance, it is essential to note that there are still a number of concerns regarding its application and how charities may comply with it. Some of the concerns that have been raised by the sector include:

- the Fundraising Guidance is set out in two separate documents rather than one consolidated document, with a detailed list of questions and answers in the Guidance that deals with issues that are not addressed in the Guidance;

- many of the factors and criteria used by CRA to evaluate fundraising activities are open to subjective interpretation;

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[57] A detailed review of the Fundraising Guidance is outside the scope of this paper. For a more detailed analysis of CRA's Fundraising Guidance see, Terrance S. Carter, "The Revised CRA Guidance on Fundraising: Improved but Still Challenging." *Charity Law Bulletin No. 169* (June 25, 2009) (online: http://www.carters.ca/pub/bulletin/charity/2009/chylb169.pdf), and Robert B. Hayhoe and David P. Stevens, "Charities and Non-Profits," (Susan M. Manwaring and Andrew Valentine, "Comments On CRA Fundraising Guidance") (2010), vol. 58, no. 3 Canadian Tax Journal, 751-770.

- although the "best practices" and "areas of concern" are not necessarily requirements that have to be followed by a charity, the enumeration of these factors in the Fundraising Guidance implies that charities are generally expected to adopt the said best practices and avoid the areas of concern;

- the level of required disclosure by charities of their fundraising costs is not clear;

- the calculation of the fundraising ratio on a fiscal year basis rather than on a rolling 12 month basis;

- non-application of the fundraising ratio to revenue received from other charities;

- uncertainty of how the Fundraising Guidance applies to registered charities whose charitable purpose is to raise funds and support other qualified donees (e.g., foundations established to support parallel operating charities):

- the theoretical application of the Fundraising Guidance to charities that operate lotteries governed by Provincial Gaming Commissions; and

- CRA auditors may not be adequately versed around the use and purpose of the Fundraising Guidance, etc.[58]

It will remain to be seen whether these concerns will be addressed by CRA in the future. As well, as indicated in the 2010 Budget, in the event that the Government was to determine that regulation of charities' fundraising activities by the Fundraising Guidance is not sufficiently effective, the Government may take further action to ensure its stated objectives are achieved.

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[58] See Carter, *supra* note 57; and Canadian Bar Association, submission by the Charities and Not-for-Profit Law Section to Canada Revenue Agency on Guidance CPS-028 — Fundraising by Registered Charities, October 2010 (online: http://www.cba.org/CBA/submissions/pdf/10-68-eng.pdf).

6. Allocation of expenses

Although the 2010 Budget greatly simplified the disbursement quota rules, charities will still have to continue to struggle with allocating their expenses into different categories, including charitable, administration, fundraising, political and business expenditures. This is because only charitable expenses would qualify for meeting the 3.5% disbursement quota rule and the immediate disbursement requirement. For example, when completing the T3010-1 information return, charities still have to report their charitable expenditure on line 5000, management and administrative expenditures on line 5010, fundraising expenditures on line 5020, expenditures for political activities online 5030, and other expenses on line 5040.

However, it has been pointed out by many in the sector that with the repeal of the 80% disbursement quota, it is questionable whether it is still necessary to distinguish between these types of expenditures. These expenditures overlap and, as noted by Justice Iacobucci in *Vancouver Immigrant Women's Society*, it is next to impossible to allocate certain expenses between these categories.[59] As well, since financial statements and generally accepted accounting principles already require charities to reflect expenses in a manner that allows CRA and the general public to determine the nature of the expenditures of the organization, they already provide sufficient transparency about whether donations and revenues of the charities are being effectively utilized.[60]

7. Disbursement quota excess and shortfall

If a registered charity has a surplus in its disbursement quota for any given year, i.e., it expends more than the required 3.5% disbursement quota, it can carry the excess forward to make up disbursement quota shortfalls in any of the following 5 years. Similarly, a surplus can be used to make up a shortfall in the immediately preceding fiscal year.[61] As such, if a registered charity has a shortfall in a year, the shortfall can be met by spending a sufficient amount in the following year.

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[59] *Vancouver Society of Immigrant and Visible Minority Women v. Minister of National Revenue* [1999] 1 S.C.R. 10.
[60] See submission by Canadian Bar Association, *supra* note 58.
[61] Subsections 149.1(20) and (21) of the Act.

However, with the repeal of the 80% disbursement quota and charities only having to meet the 3.5% disbursement quota, it is anticipated that there would be many occasions where charities would have a disbursement quota excess, as opposed to a disbursement shortfall. For example, if a charity has $1 million in investment assets, which result in a $35,000 disbursement obligation for its 3.5% disbursement quota (assuming that the value of the investment assets remained the same over the years). Assume the same charity has an annual budget of $250,000 and it received $250,000 in donations in 2011. If the charity disburses the entire $250,000 for its operations (assume 100% of the disbursement is charitable), after utilizing $35,000 of the $250,000 of expenditure in meeting its 3.5% disbursement quota, it will have $215,000 in disbursement quota excess to carry forward for 5 years. Assuming that the investment assets continue to remain at the same amount for the next 5 years, the total 3.5% disbursement quota for the next 5 years would be $175,000. As such, the $215,000 in disbursement quota excess from 2011 would be more than sufficient to meet the 3.5% disbursement quota for the following 5 years and, in theory, there would be no need for the charity to have any charitable expenditure for that 5 year period.

8. Accumulation of property

Charities that intend to engage in large capital projects, e.g., purchasing new buildings or equipment, may have to finance these by accumulating revenue over a number of years. In that case, charities may seek approval from CRA to accumulate property pursuant to subsection 149.1(8) of the Act as explained above.[62] Once permission is granted under the new disbursement quota rules, the property accumulated (including interest earned) with CRA's permission will be excluded from the asset base in calculating the 3.5% disbursement quota. As such, the charity would not be required to expend 3.5% of it in meeting its disbursement quota.[63]

Prior to the repeal of the 80% disbursement quota, the request to accumulate property was a very useful tool if the property to be accumulated consisted of receipted donations, in order to avoid having to expend 80% of such donations in meeting the 80% disbursement quota, However, with the repeal of the 80% disbursement quota, the disbursement obligation is greatly reduced to 3.5%,

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[62] *Supra* page 15.
[63] Canada Revenue Agency, webpage "Asking for permission to accumulate property (funds)" (online: http://www.cra-arc.gc.ca/chrts-gvng/chrts/prtng/rqsts/ccmlt-eng.html).

which may not be difficult to meet. As well, there is a delaying effect in a charity being required to actually make disbursements from donations received in a year because the 3.5% disbursement quota is based on a rolling average value of the assets for a 24 month period prior to the fiscal year in question. For example, the 3.5% disbursement quota for 2011 is based on the average value of the investment assets of the charity from January 1, 2009, to December 31, 2010. Donations received in 2011 would not need to be disbursed until 2012. As well, the average value of the investment assets is based on the value of the assets over the 24 months, which can be divided into 2 to 8 periods as decided by the charity. As such, donations received late in a year will result in a lower overall average value of the assets over the 24 month period, which will compound the delay effect in making disbursements.[64] It is therefore anticipated that there will be fewer occasions that may require seeking CRA's approval to accumulate property.

9. Disbursement quota reduction

It is possible that a registered charity is unable to make sufficient expenditures on charitable activities or on gifts to qualified donees due to circumstances beyond their control, thus causing the charity to incur a disbursement quota shortfall. In that situation, the charity may apply to CRA for a reduction in the disbursement quota pursuant to subsection 149.1(5) of the Act by completing Form T2094 - Registered Charities: Application to Reduce Disbursement Quota.[65] Once permission is granted, CRA may allow the amount to be deemed to have been expended by the charity on charitable activities carried on by it.

The permission is only available where the disbursement quota shortfall is caused by circumstances beyond the charity's control. CRA's policy also indicates that a reduction will only be considered once the charity has exhausted all other available means to make up the shortfall, such as applying any available excesses from the previous five years to cover the shortfall, and/or creating a disbursement quota excess in the next year and carrying it back to cover the shortfall.

[64] For an explanation on how to calculate the 3.5% disbursement quota, see Canada Revenue Agency, webpage "Disbursement quota calculation" (online: http://www.cra-arc.gc.ca/chrts-gvng/chrts/prtng/spndng/clclb-eng.html) and Theresa L.M. Man, "Calculation of 3.5% Disbursement Quota for All Registered Charities," *Charity Law Bulletin* No. 150, December 18, 2008, for a detailed discussion (online: http://www.carters.ca/pub/bulletin/charity/2008/chylb150.htm).

[65] Canada Revenue Agency, Form T2094 - Registered Charities: Application to Reduce Disbursement Quota (online: http://www.cra-arc.gc.ca/E/pbg/tf/t2094/README.html).

As such, the earliest that a charity can receive approval for a disbursement quota reduction is after it has issued a Registered Charity Information Return Summary for the fiscal period following the period in which the shortfall occurred.[66] CRA's Form T2094 further states that the purpose of this alleviating provision is to allow a charity to correct a deficiency in meeting its disbursement quota – when such a deficiency is the direct result of special circumstances beyond the charity's control that are specific and not general in nature; and that this provision is not to be used as a mechanism to exempt the charity from meeting its disbursement quota, except in extraordinary circumstances. After a charity has received approval for a disbursement quota reduction, it is required to amend the T3010 return (by completing Form T1240, Registered Charity Adjustment Request) for the fiscal period in which the shortfall occurred to include the approved amount on line 5750.

As explained above, with the repeal of the 80% disbursement quota and charities only having to meet the 3.5% disbursement quota, it is anticipated that there will be many more occasions where charities will have a disbursement quota excess, which can be used to make up disbursement quota shortfalls. It is therefore anticipated that there will be fewer occasions that may require seeking CRA's approval for a disbursement quota reduction.

10. <u>New endowments and long term gifts</u>

One of the welcomed implications of the changes brought by the 2010 Budget is that charities now have more freedom to structure endowments and long term gifts, such as the length of time a gift is to be held by a charity, and payout strategy of the gift for charitable expenditure, etc.

Under the former rules, endowments and long term gifts had to be structured as ten-year gifts (which was one type of enduring property) in order to avoid the requirement to disburse 80% of the gift by the following year. A ten-year gift is a gift that is subject to a trust or direction imposed by the donor, requiring the gift (or property substituted for the gift) to be held by the charity for a period of time that is at least ten years from the date when the gift was made (the "hold period"). If

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[66] Canada Revenue Agency, webpage "Asking for a disbursement quota reduction" (online: http://www.cra-arc.gc.ca/chrts-gvng/chrts/prtng/rqsts/qt-eng.html).

it is a perpetual endowment, the hold period would be perpetuity. The donor's direction may also permit the charity to encroach on a ten-year gift before the end of the hold period up to the charity's capital gains pool for the purpose of meeting the charity's 3.5% disbursement quota.[67] This in turn required charities to struggle with the difficulty of distinguishing income, capital, realized capital gains, unrealized capital gains, etc.

With the repeal of the 80% disbursement quota and related concepts, charities now have much more flexibility in structuring endowments and long term gifts. Charities can therefore focus on balancing donors' desire for long-term financial stability of their gifts and the need of charities to have flexibility in managing endowments to meet changing economic conditions and future planning needs. As such, charities will need to carefully consider the type of issues that would need to be reviewed with potential donors when structuring new endowments and long term gifts. Examples of the type of issues that should be discussed include, the length of time that the capital of the gift is to be held by the charity, investment and payout strategy, etc.[68]

There is no longer any requirement to have the gift to be held for at least ten years. The charity may discuss with the donor an appropriate length of time for the gift to be held by the charity. At one extreme, it is possible for the capital of the gift to be held in perpetuity. However, there may be occasions where a donor may not wish for a gift to be held for a long time, let alone in perpetuity. It is also possible to structure the hold period using more creative options, such as establishing a fund for a defined period of time (e.g., 15 years, 25 years, etc.), where the capital would be invested during this time, and both the capital and income would be spent at the end of the period or at different times during this period. Examples of factors to take into consideration when deciding an appropriate length of hold period could include: the charity's investment strategy; the charity's long term planning; the charity's wish or need to access the capital in later years (e.g., major projects that may be implemented in 20 years); the charity's cash flow; the donor's desire to leave

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[67] See explanation on page 6. For a detailed explanation on enduring property, see Theresa L.M. Man, "Enduring Property and the Disbursement Quota", *Charity Law Bulletin* No. 171, July 29, 2009 (online: http://www.carters.ca/pub/bulletin/charity/2009/chylb171.pdf).
[68] For an overview of the issues, see Elizabeth Moxham, "Endowments 2.0: Rethinking Endowments in the New World", Gift Planning in Canada, Vol. 15, Number 5, May 2010 (online: http://www.giv3.ca/upload/pressrooms/46_ARTICLE-Gift%20Planning-May%2010.pdf) and Susan Manwaring and Jill McAlpine, "Endowment How to structure and Plan for the Future – Revisited Post Budget 2010", PowerPoint presentation to the Ontario Bar Association, Toronto, September 21, 2010.

a long term legacy; the useful life of the designated charitable purpose of the fund (e.g., what would happen to a perpetual endowment fund established to support a particular program in the event that the charity no longer operates that program); the nature of the assets held in the endowed gift (e.g., a donor wanting to gift a piece of real property to the charity to create an endowment and require the real property be held in species); the infra-structure of the charity to track different hold periods for different funds; and the ease of administration of the charity, etc.

It is also possible for charities to structure a more flexible investment and payout strategy with donors. For example, the gift may be subject to a payout strategy such as a total return investment and payout strategy that reflects investment strategy of the charity and the desirable rate of expenditure, etc. A total return investment and payout strategy permits investments to be made for the purpose of achieving the maximum possible return consistent with an acceptable level of risk and without regard to whether receipts are income in the traditional sense or capital gains. As well, charitable distribution will be calculated as an appropriate percentage of the total return irrespective of their source in income or capital gains. This approach provides a balance between the need to generate sufficient income for the charitable purposes and the need to maintain capital growth over time for future distribution.[69] If a charity would like to utilize a total return investment and payout strategy, it would need to discuss with the donor specifics of the strategy, whether the encroachment is to be based on a certain percentage of the assets of the gift, etc. However, if a charity does not wish to utilize this strategy, then it would need to discuss with the donor various issues, such as how relevant concepts (such as capital, income, capital gain, etc.) are to be defined; and how much of the annual income would be disbursed (e.g., mandatory requirement for the charity to disburse all of the annual income; mandatory requirement on the charity to disburse all of the income up to the amount required to meet the 3.5% disbursement quota; discretionary right of the charity to decide how much, if any, income to disburse, etc.).

[69] For example, *Re Killam Estate* (1999) 38 ETR (2d)142 and *The Toronto Aged Men's and Women's Homes et al. v. The Loyal True Blue and Orange Home et al.* (2003), 68 O.R. (3d) 777, sub. nom. *Stillman Estate* (re) (SCJ). In both cases, testamentary trusts had been established for charitable purposes and the trustees had been directed to maintain a capital fund in perpetuity with only the income to be used to fund charitable activities. Investment restrictions were also imposed by the testator. An application to the court was brought because income generated by the trust's capital assets was insufficient to meet the charity's disbursement quota. Rather than allowing the trustees to encroach on the capital of the fund, the court approved a total return investment and payout scheme.

Since the restriction limiting the ability of a charity to encroach on the capital of a ten-year gift to the extent of the capital gains pool for the purpose of meeting its 3.5% disbursement quota has been removed, it is now possible for a charity to discuss with its donor when and how the charity may have access to the capital of an endowment or long term gift prior to the expiry of the hold period of the gift. Therefore, issues to discuss with donors in relation to the power of the charity to encroach on the capital of the gift may include: whether the charity may encroach on the capital of the fund; the circumstances under which the capital may be encroached; whether there is any limit or restrictions on the encroachment; whether the encroachment would be subject to the donor's non-binding advice, etc.

Of course, charities will continue to need to discuss with donors non-disbursement quota related gift issues, such as the charitable purpose of the gift, non-binding donor advice, donor recognition, administrative fees, gift variance clause, flexibility, etc. Where possible, it would be beneficial to build in as much flexibility as possible to allow the recipient charity to deal with unforeseen circumstances.

Charities will also need to revise internal gift policies, e.g., gift acceptance policies, endowment fund policies, etc.; revise template gift documents; revise their publications concerning gifting issues, e.g., website, planned giving promotion materials, donor communications, etc.; as well as educate donors and staff of the new policies.

11. <u>Existing endowments and long term gifts</u>

Although charities have much more freedom in structuring new endowments and long term gifts, endowments and long term gifts that were in place before the implementation of the 2010 Budget changes continue to be subject to the provisions contained in the respective gift agreements. Many endowment agreements prepared under the former disbursement quota rules only provide for distribution of income but no right to encroach on the capital; require the capital be held for at least ten years in order to be a ten-year gift; and may permit encroachment according to the previous restriction of meeting the 3.5% disbursement quota up to the amount in the charity's capital gains pool.

With the repeal of the capital gains pool and ten-year gift concepts under the 2010 Budget, it is not clear how the new disbursement quota may affect, if at all, existing endowments.[70] Examples of questions that charities may have include: whether the capital can be encroached upon during the ten-year period since the ten-year gift concept has been repealed; whether charities are still required to track the 10-year period; and whether the terms of the a 10-year gift could be varied if the terms of the gift agreement do not permit encroachment of capital, etc.

The response to these questions will depend on whether the endowment fund or long term gift is subject to a trust imposed by the donor or if it was established by the charity (such as an internally restricted fund established by the board). A determination of these issues will require a careful review of the terms of the gifts, who imposed the gift restrictions and the circumstances under which the restrictions are imposed. In this regard, a review of a number of documents will be required, including existing gift agreements and donors' directions; the charity's governing documents (including letters patent, articles, constitution, memorandum of association, trust deeds, bylaws and all subsequent changes to these documents); policies of the charity relating to spending, distribution of funds, investment policies; and publications for fundraising or reporting or other donor communications. In reviewing these documents, the applicable regulatory context would also need to be reviewed, including the Act, provincial legislation, and the common law (especially trust law).

If it was determined that a particular endowment fund or long term gift was subject to restrictions imposed by the donor at the time when the gift was made, the gift would likely constitute a

[70] For a review, see M. Elena Hoffstein, "Amendments to the Disbursement Quota Regime in Canada's Federal Budget 2010", *STEP Journal,* September 2010, Volume 18 (online: http://stepjournal.org/journal_archive/2010/step_journal_september_2010/great_benefit.aspx); Susan Manwaring and Jill McAlpine, "Endowment How to structure and Plan for the Future – Revisited Post Budget 2010", PowerPoint presentation to the Ontario Bar Association, Toronto, September 21, 2010); M. Elena Hoffstein, "Post-DQ – What to do?", PowerPoint presentation to the 18th Annual National Canadian Association Of Gift Planners Conference, Toronto, April 14, 2011.

charitable purpose trust to be managed by the charity for the purposes imposed by the donor.[71] A detailed review of the applicable trust issues is outside the scope of this paper.[72] However, for the purpose of this paper, the following sets out the applicable key issues.

It is important to note that a gift in trust may be created expressly in writing, such as an endowment agreement, if it clearly states that the gift is to be held in trust and the basic three certainties of a trust (i.e., certainty of intention, certainty of subject matter, and certainty of objects) are met. A gift in trust may also be created impliedly if the circumstances surrounding the gift or the general language in the document accompanying a gift are sufficient to establish that the donor intended the gift to be held in accordance with a special purpose charitable trust.[73] Where there is no gift agreement, the charity will need to review the circumstances involving the gift to determine whether an implied trust is created and to ascertain the applicable terms of reference. Even where there is a gift agreement, it is also important to review these circumstances involving the gift to determine whether there are any implied terms that may not have been clearly set out in the gift agreement.

If a charity fails to comply with the donor restrictions of a special purpose charitable trust, all of the directors of the charity may be exposed to personal liability for allowing or acquiescing to the improper application of charitable property. They may also be held personally liable for breach of trust and be jointly and severally liable for the full amount of any loss suffered by the charity as a

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[71] See *Ulverston & District New Hospital Building Fund (Re)*, [1956] 3 All E.R. 164 at 168–169 (C.A.); *Attorney-General for Queensland v. Cathedral Church of Brisbane* (1977), 136 C.L.R. 353 at 371 (H.C.A.); *Young Women's Christian Association Extension Campaign Fund (Re)*, [1934] 3 W.W.R. 49 at 52 (Sask. K.B.); *Church Army (Re)* (1906), 94 L.T. 599 (C.A.); *Lucas (Re)*, [1948] 2 All E.R. 22 at 25–26 (C.A.); and *Finger's Will Trusts (Re)*, [1972] Ch. 286 at 294–295. See also *Christian Brothers of Ireland in Canada (Re)* (1998), 37 O.R. (3d) 367 (Ct. J. (Gen. Div.)), 21 E.T.R. (2d) 93, rev'd (2000), 47 O.R. (3d) 674 (C.A.) [*Christian Brothers Gen. Div*.]; *Christian Brothers of Ireland in Canada (Re)* (2000), 47 O.R. (3d) 674 (C.A.), rev'g (1998), 37 O.R. (3d) 367, leave to appeal to S.C.C. refused, [2000] S.C.C.A. No. 277 (QL) [*Christian Brothers Ont. C.A.*]; *Rowland v. Vancouver College Ltd.* (2000), 78 B.C.L.R. (3d) 87 (S.C.), 34 E.T.R. (2d) 60, aff'd (2001), 94 B.C.L.R. (3d) 249 (C.A.) [*Christian Brothers B.C.S.C.*]; *Rowland v. Vancouver College Ltd.* (2001), 94 B.C.L.R. (3d) 249 (C.A.), aff'g 78 B.C.L.R. (3d) 87 (S.C.), leave to appeal to S.C.C. refused, [2001] S.C.C.A. No. 652 (QL).

[72] For a detailed review, see Terrance S. Carter, "Donor-Restricted Charitable Gifts: A Practical Overview Revisited II", reprinted from 18 *The Philanthropist* 5 (2003) & 121 (2004) (Paper presented to the 2006 Annual National Conference, Canadian Association of Gift Planners, April 21, 2006) at 52-56 (online: http://www.carters.ca/pub/article/charity/2006/tsc0421.pdf). See also Terrance S. Carter, "Considerations When Drafting Restricted Charitable Purpose Trusts" paper presented to the Ontario Bar Association, Trusts, Trustees, Trusteeships 2010, October 1, 2010 (online: http://www.carters.ca/pub/article/charity/2010/tsc1001.pdf).

result of the failure to comply with the terms of trust, either at common law[74] or other applicable legislation (such as the *Charities Accounting Act*[75] in Ontario).

Where the donor's restrictions are either impossible or impractical to comply with or where the means of carrying out the special purpose charitable trust can no longer be realistically accomplished, it is beyond the power of the donor or the charity to vary the terms of the trust. As such, a charity will not be able to encroach on the capital of a gift if the terms of trust do not permit encroachment. In those situations, the charity must seek the assistance of the court in exercising its general scheme-making power through either a *cy-près* court application or the imposition of an administrative scheme. In Ontario, section 13 of the *Charities Accounting Act* (Ontario) provides an inexpensive and simple way to get a court order with the consent of the Ontario Public Guardian and Trustee.[76] It is therefore possible to apply to the court to vary the terms of an endowment where appropriate.[77]

However, where the terms of a fund are imposed by the board as an internally restricted fund, then the applicable corporate documents would need to be reviewed to determine whether it is possible and if so how to revise those terms. If the restrictions are imposed by the charity's constating documents (e.g., a provision in the letters patent or by-laws regarding investment or payout strategy of the funds of a charity), then the charity may need to review whether it is possible to revise those terms, e.g., whether there are any restrictions to amend those terms under the applicable incorporating statute or the charity's governing documents. If it is possible to amend those provisions, then the charity will need to review the procedures for the amendment and whether there are any disadvantages in amending them. The charity will also have to review the procedures on how the amendment is to be made.

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[73] Donovan W.M. Waters, Mark R. Gillen & Lionel D. Smith, eds., *Waters' Law of Trusts in Canada*, 3rd ed. (Toronto: Thomson Carswell, 2005) at 20, 132-135.

[74] See *Re Public Trustee and Toronto Humane Society et al., (1987), 40 D.L.R. (4th) 111 (Ont. H.C.J.); Re David Feldman Charitable Foundation* (1987), 58 O.R. (2d) 626 (Surr. Ct.); *Faith Haven Bible Training Centre (Re)* (1988), 29 E.T.R. 198 (Ont. Surr. Ct.); *Re Harold G. Fox Education Fund et al. and Public Trustee* (1989), 69 O.R. (2d) 742, 34 E.T.R. 113 (H.C.J.).

[75] R.S.O. 1990, c. C.10.

[76] See Ontario Public Guardian and Trustee' website at http://www.attorneygeneral.jus.gov.on.ca/english/family/pgt/proc4order-s13-CAA.pdf on how to obtain such a court order.

[77] See for example, *Re Killam Estate* and *Re Stillman Estate, supra* note 69.

12. Corporate sponsorships

Prior to the 2010 Budget, if a charity was to issue a donation receipt for sponsorship, this would increase the charity's 80% disbursement quota obligation.[78] With the repeal of the 80% disbursement quota pursuant to the 2010 Budget, some charities may think that it does not matter whether a donation receipt is issued for the sponsorship, since such a receipt will not impact its disbursement quota. However, this is hardly the case.

In this regard, "sponsorship" is not a defined term in the Act. CRA used to take the view that "sponsorship fees" are "not gifts because the sponsor receives something in exchange" and "they are usually paid to support a charity event in return for advertising or some other consideration." CRA's website indicates that its policy on the treatment of "sponsorship fees" in this regard is currently under revision.[79] Under the Act, a corporation can obtain a donation receipt for having made a gift pursuant to subsection 110.1(1) and claim a tax deduction against its income. In this regard, the deduction is limited up to a maximum of 75% of net income, plus 25% of certain taxable capital gains, and 25% of any capital cost recapture.[80] However, the deduction of sponsorship fees as business expenses under section 18 of the Act is not so limited, provided that the deduction is made in respect of an outlay or expense that was reasonable in the circumstance required under section 67 of the Act.

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[78] For a more detailed review of the treatment of corporate sponsorship under the Act, see Theresa L.M. Man, "Corporate Giving: A Tax Perspective", September 18, 2006 (online: http://www.carters.ca/pub/article/charity/2007/tlm_corpgiving.pdf); and Carole Chouinard, "Considerations in Corporate Giving", *The Philanthropist*, Volume 21, No. 4 at 297.
[79] Canada Revenue Agency, *Summary Policy* CSP-S13, "Sponsorship," September 3, 2003.
[80] These provisions do not apply to gifts of cultural property or ecological gifts.

Although the eligible amount of a donation receipt issued for sponsorship no longer impacts the disbursement quota of the charity, the split-receipting rules[81] would require that the sponsoring business does not receive any advantage in return for the sponsorship if it was to be receipted. As such, it is necessary for a charity to determine whether the business received any advantage in respect of the sponsorship provided and that the eligible amount of any donation receipt issued reflects the fair market value of the sponsorship, less the value of advantage received by the business.

H. CONCLUSION

To conclude, the significant changes to the disbursement quota rules brought by the 2010 Budget have had many positive impacts on charities, including simplifying the calculation of the disbursement quota, relieving charities from spending scarce resources in complying with the previously complicated disbursement quota regime, and allowing charities more freedom in structuring endowment and long term gifts.

However, there are also a number of concerns regarding these new changes, such as the broad application of the non-arm's length inter-charity gifts provision and prohibition of transactions to avoid or unduly delay charitable expenditure. As well, the increased importance of compliance with CRA's Fundraising Guidance is not without concerns. The 2010 Budget indicated that if the Government felt that the regulation of charities' fundraising activities by the Fundraising Guidance

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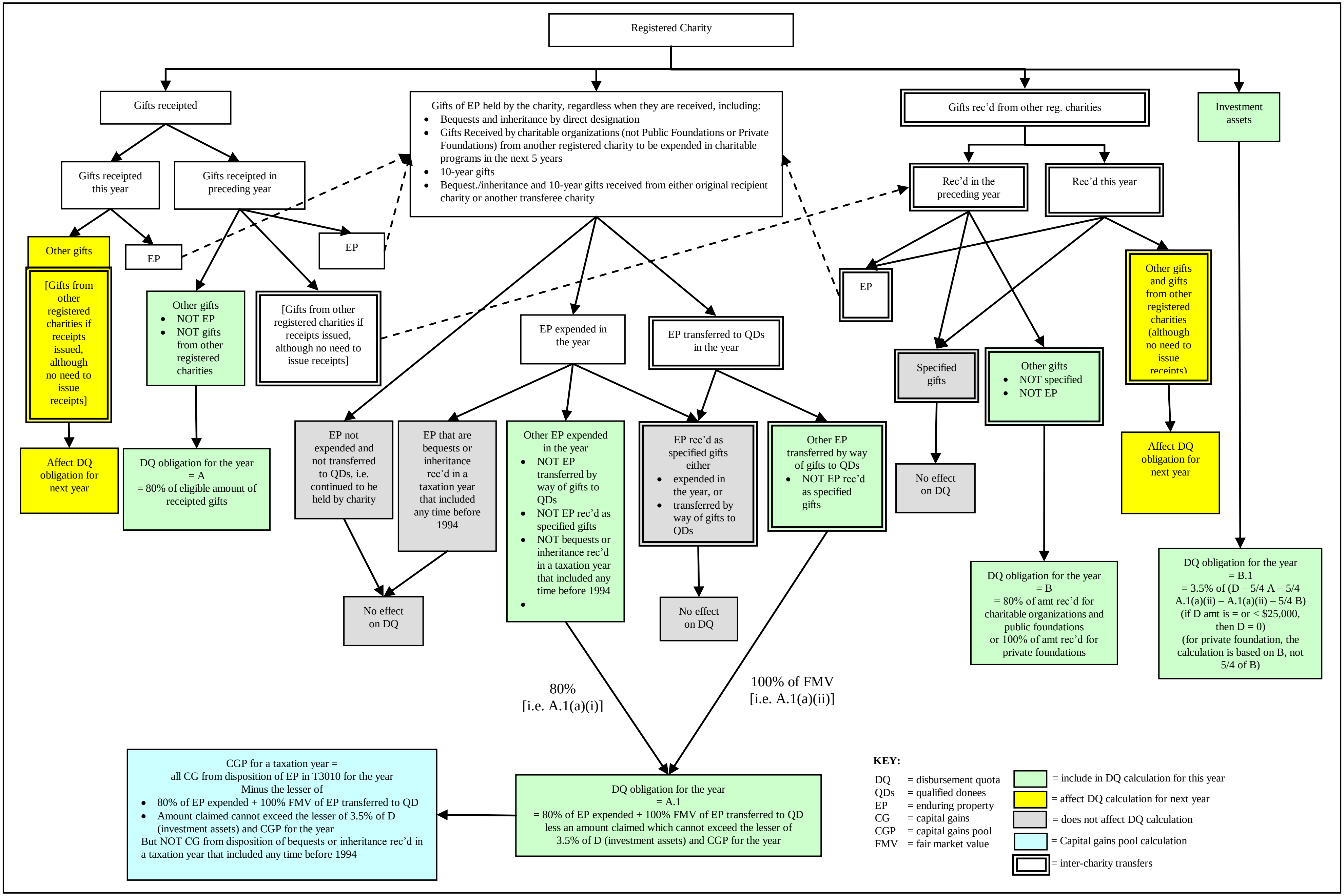
[81] Subsections 248(30) to (41) are proposed to be introduced in the Act to allow a donor to receive a donation tax receipt even in situations where the donor or someone else receives a limited advantage as a result of the gift. This is referred to as "split-receipting." Some of the proposed changes in this regard also stem from the Department's intention to curtail abusive tax shelter schemes involving charitable donations. These changes generally apply to gifts made after December 20, 2002, with a few exceptions. The proposed changes were first introduced by Finance on December 20, 2002. These amendments underwent various incarnations over the years, namely on December 5, 2003, February 27, 2004, July 18, 2005, and were introduced as Bill C-33 on November 29, 2006, which died on the Order Paper since Parliament was prorogued on September 14, 2007. The changes were re-introduced as Bill C-10 on October 29, 2007, but Bill C-10 again died on the Order Paper on September 7, 2008, when Parliament was dissolved after an election was called. These changes are again contained in draft legislative proposals released on July 16, 2010. Although these proposed changes have yet to be enacted into law, the split-receipting rules have already been implemented by CRA in their administrative policies. For an overview, see Theresa L.M. Man, "Recent Income Tax Act Amendments That Affect Charities," Charity Law Bulletin No. 221, July 29, 2010 (online: http://www.carters.ca/pub/bulletin/charity/2010/chylb221.pdf). See also John Loukidelis, "Comments on Certain Proposed Tax Rules Applicable to Charities: Gifts to Foreign Entities, Large Gifts and 'Split Receipts'", Ontario Bar Association, *A Danger to Dabble - Charity Law Hot Spots* (October 26, 2005).

was not sufficiently effective, the Government may take further action to ensure its stated objectives are achieved.

Annex I
Disbursement Quota Rules Prior to the 2010 Budget



Annex II

Disbursement Quota Rules Introduced by the 2010 Budget