

SIGNIFICANT BENEFIT FOR CHARITIES IN 2010 FEDERAL BUDGET DQ REFORM

*By Karen J. Cooper and Terrance S. Carter**

A. INTRODUCTION

A significant measure in the Federal Government's 2010 Budget¹ that will find strong support from across the charitable sector in Canada is the provision eliminating the 80% disbursement quota for registered charities and increasing the exemption from the 3.5% disbursement quota (collectively referred to as the "DQ"). Over the years, the DQ has created an unnecessarily onerous administrative burden on registered charities that few charities and their staff have had the ability to comply with, let alone understand. These burdensome complexities include having to wrestle with complicated concepts of enduring property, ten year gifts, capital gains pools and inter-charity transfers. The 80% DQ was particularly difficult for small and rural charities to comply with because they tend to be more dependent on receipted income than large charities that often receive more of their income from non-receipted sources. Eliminating the 80% DQ will therefore be of particular help to small and rural charities, increased assistance for which has been a priority for the Canada Revenue Agency ("CRA") over the last few years.

B. DISBURSEMENT QUOTA

The DQ was introduced in 1976 to help curtail fundraising costs, to limit capital accumulation, and to ensure that a significant portion of a charity's resources are devoted to charitable activities, as opposed to

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¹ See Department of Finance website at <http://www.budget.gc.ca/2010/plan/anx5-eng.html> for details.

administrative costs. The *Income Tax Act* (“ITA”) currently provides that all registered charities are required to annually expend a portion of their assets in accordance with a disbursement quota (“DQ”), which is a prescribed amount that registered charities must disburse each year in order to maintain their charitable registration. In general terms, the DQ requires that the amount a charity spends each year on charitable activities (including gifts to other charities) be at least equal to 80 per cent of the previous year's tax-receipted donations (referred to as the "charitable expenditure rule" or the 80% DQ) and 3.5 percent of the charity's investment assets (referred to as the “capital accumulation rule” or 3.5% DQ). New DQ rules were enacted in Bill C-33 on May 13, 2005,² and apply generally to taxation years beginning after March 22, 2004, except that, for charitable organizations registered before March 23, 2004, the 3.5 % DQ only applies to their taxation years beginning after 2008.

The DQ rules are too complex to detail here,³ but the calculation of the DQ has occurred in accordance with a complicated formula consisting of two parts: the 80 % DQ aimed at limiting administrative expenses and the 3.5 % DQ aimed at preventing the accumulation of funds. The main features of the disbursement quota for charitable organizations and public foundations that have been in place prior to the 2010 Budget may be summarized as follows:

1. The 80 per cent disbursement quota is equal to (1) 80 per cent of gifts received in the immediately preceding year (except gifts of enduring property and gifts received from other registered charities), plus (2) 80 per cent of enduring property expended in the year and 100 per cent of enduring property transferred to qualified donees in the year, less the optional reduction by the amount of realized capital gains on enduring property, plus (3) 80 per cent of gifts received from other registered charities (except specified gifts or enduring property).

The primary concern for most organizations with respect to this part of the DQ is ensuring that they clearly identify what may be considered enduring property in accordance with the definition in section 149.1(1) of the ITA: gifts by way of bequest or inheritance; 10-year gifts; life insurance proceeds, registered retirement income funds and registered retirement savings plans as a result of direct beneficiary designation; and gifts received by the charity as a transferee of an enduring property from either an original recipient charity or another transferee charity.

² The *Budget Implementation Act, 2004, No. 2*, S.C. 2005, c. 19 (Bill C-33).

³ See *Charity Law Bulletin* Nos. 59, 61, 67, and 69, available online at www.charitylaw.ca for detailed explanation and chart.

- Charities are also required to expend at least 3.5 per cent of their assets that are not used directly in its charitable activities or administration (commonly referred to as “investment assets”). The value of the assets in this regard is based on 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.⁴

The disbursement quota rules for private foundations have been very similar to those for charitable organizations and public foundations, except that private foundations had been required to expend 100 per cent (rather than 80 per cent) of all amounts received from other registered charities in the immediately preceding taxation year, other than specified gifts and enduring property.

C. CBA CONCEPT PAPER AND CALLS FOR REFORM

On June 11, 2009, the Charities Directorate of CRA released its much anticipated Guidance (CPS-028): *Fundraising by Registered Charities* (the “Guidance”), that applies to fundraising activities by registered charities.⁵ The Guidance, which includes 23 pages of additional information, replaces CRA’s previous policy on fundraising and provides detailed guidance for charities on acceptable fundraising practices.⁶ In general, a registered charity is required to report all fundraising expenditures in its T3010B annual information return, which expenditures include “all costs related to any activity that includes a solicitation of support, or that is undertaken as part of the planning and preparation for future solicitations of support.” These expenditures will be evaluated based on the measurement of the ratio of fundraising costs to fundraising revenue in a fiscal year (note that the ratio is unrelated to the DQ):

- Less than 35% - it is unlikely to generate questions or concerns
- Greater than 35% and above - CRA will examine the average ratio over recent years to determine if there is a trend of high fundraising costs. The higher the ratio, the more likely it is that there will be concerns and a need for a more detailed assessment of expenditures.

⁴ The 3.5 per cent DQ does not apply if the amount of property owned by the charity in this regard is \$25,000 or less. The detailed method for the calculation of the 3.5 per cent DQ 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)). Please 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 (<http://www.carters.ca/pub/bulletin/charity/2008/chylb150.htm>).

⁵ 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>.

⁶ For a detailed discussion of the Guidance see *Charity Law Bulletin* no. 169 available at <http://www.carters.ca/pub/bulletin/charity/2009/chylb169.pdf>.

- Above 70% - This level will raise concerns with the CRA and will likely result in revocation.

With the publication of the Guidance and other legislative and administrative initiatives, the 80% DQ became less relevant for curtailing fundraising and other administrative expenses.

In July 2009, 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* to the federal Department of Finance, which indicated that the DQ regime results in substantial distortions of the gifting decisions of donors to charities and in investment decision-making by charities. The CBA *Concept Paper* addresses the four specific regulatory objectives pursued by the current DQ regime: (1) current gifts disbursement; (2) anti-accumulation; (3) efficiency; and (4) fundraising efficiency. According to the CBA submission, the only regulatory objective that should be pursued through a DQ regime is the prevention of undue accumulation of donations, income and capital. The *Concept Paper* argued that the current regime was not an effective means of achieving administrative efficiency and limiting fundraising expenses. The CBA proposed that the third regulatory objective could be more effectively pursued through increased transparency and the fourth objective is best dealt with in CRA's fundraising guidelines.

The *Concept Paper* made a number of recommendations for reform, including the complete repeal of the charitable expenditure rule or the 80% DQ and modifications to the 3.5% DQ. This recommendation would result in a simplification of the DQ calculation and the repeal of complex and difficult to understand concepts whose function was to sort donations into current and capital components. 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.

D. 2010 BUDGET

As a result of recommendations from the sector and the CBA, the 2010 Federal Budget proposes to reform the DQ for fiscal years that end on or after March 4, 2010 by completely repealing the charitable expenditure rule (80% DQ). As a result, charities will no longer be required to spend at least 80 per cent of the previous year's tax-receipted donations. With the repeal of the charitable expenditure rule, many of the complicated concepts discussed above will no longer form part of the DQ calculation, including enduring property, the capital gains reduction and the capital gains pool and specified gifts. Among the proposed technical

amendments to the *Income Tax Act* included in the Budget is the repeal of the definitions of “capital gains pools,” “enduring property” and “specified gift.”

In addition, the existing threshold for the requirement that charities spend an amount equal to 3.5 per cent of their investment assets each year (the capital accumulation rule or the 3.5% DQ) if the total investment assets exceeds \$25,000 is increased to \$100,000 for charitable organizations. This will reduce the compliance burden on small charitable organizations and provide them with greater ability to maintain reserves to deal with contingencies. The threshold for charitable foundations will remain at \$25,000.

The Budget also contains proposed measures extending existing anti-avoidance rules to situations where it can reasonably be considered that a purpose of a transaction was to delay unduly or avoid the application of the DQ. The purpose of these amendments is to ensure that amounts transferred between non-arm’s length charities will be used to satisfy the DQ of only one charity. The Budget proposes that the recipient charity will be required to expend the full amount transferred. Alternatively, the transferring charity will be able to elect that the amount transferred will not count toward satisfying its DQ, in which case the recipient charity would not be subject to the immediate disbursement requirement. The Budget contains penalty provisions for registered charities that participate in such avoidance transactions. A registered charity that has entered into a transaction (including a gift to another registered charity) and it may reasonably be considered that a purpose of the transaction was to avoid or delay unduly the expenditure of amounts on charitable activities; the registered charity will be liable to a penalty equal to 110% of the amount of expenditure avoided or delayed. In the case of a gift to another registered charity, both charities are jointly and severally, or solidarily, liable for the penalty. In addition, if a registered charity has received a gift (other than a designated gift) from a non-arm’s length charity, and has not expended, before the end of the next taxation year an amount at least equal to the amount of the gift on its own charitable activities or as gifts to other arm’s length qualified donees, in addition to its DQs for those taxation years, the charity will be liable to a penalty equal to 110% of the amount by which the fair market value of the property exceeds the total of such amounts expended.

The repeal of the charitable expenditure rule will necessitate amendments to the rules regarding the accumulation of property for a particular purpose, such as a building project. Currently, any property accumulated after CRA approval has been obtained and any income earned in respect of that property is

deemed to have been spent on charitable activities. The Budget proposes an amendment under which CRA will be given the discretion to exclude the accumulated property from the capital accumulation rule calculation (the 3.5% DQ).

Another proposed measure in the Budget of interest to Charities is an extension of the mineral exploration tax credit, an important component of many flow-through share gifting arrangements. Further, in its discussion of the DQ, the federal government noted that it will monitor the effectiveness of CRA's guidance on "Fundraising by Registered Charities" and take action if needed to ensure its stated objectives are achieved.

E. STEPS BY CRA

CRA has indicated that it will be required to make several administrative changes in response to the DQ reform proposed by the 2010 Federal Budget.⁷ CRA will produce new instructions on how to calculate the DQ for fiscal years that end on or after March 4, 2010 and charities should watch for new information expected to be posted to CRA's website soon. In addition, the Registered Charity Information Return, Form T3010B will also need to be revised to reflect the new DQ calculation and CRA has indicated that charities must continue to use the existing form until a new form is released.

F. CONCLUSION

The proposed repeal of the charitable expenditure rule and increase to the threshold for the application of the capital accumulation rule will have a substantial positive impact on charities, decreasing substantially the administrative complexity of complying with the DQ, particularly for small and rural charities. No longer will charities have to struggle with structuring long-term gifts or endowment funds to comply with complex *Income Tax Act* language related to enduring property. They will, instead, be able to focus their efforts on balancing donor desires for long-term financial stability with the need for flexibility to meet changing economic conditions. Charities and their financial advisors will not have to spend scarce resources accounting for and allocating expenses between those related to carrying on charitable activities and overhead or administrative expenses. Instead, the focus will be on complying with CRA's guidance with respect to fundraising expenditures to ensure that excessive fundraising costs are avoided.

⁷ See news release by the Canadian Council of Christian Charities for details, available at http://www.cccc.org/news_release/95.

As a result of the proposed changes, it is likely that charities and their advisors will see changes to the *Registered Charities Annual Information Return* (T3010B) reflecting the simplification of the DQ regime. In addition, charities and their advisors will have to carefully monitor compliance with the CRA fundraising Guidance and review future deeds of gift or endowment agreements to eliminate any restrictions specifically related to the exemption from the charitable expenditure requirement, although other restrictions in existing deeds of gifts or endowment agreements will still need to be complied with. Finally, charities and their advisors will have to carefully consider transitional issues and any guidance provided by CRA in this regard.