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**Disbursement Quota Reform: The Ins and
Outs of What You Need to Know**

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A. OVERVIEW

- Background
- Pre-2010 federal budget DQ rules
- CBA concept paper
- 2010 budget new DQ rules
- CRA's action
- Implications of new DQ rules

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B. BACKGROUND

- DQ is prescribed amount that registered charities must disburse each year in order to maintain charitable registration
- Purposes of DQ
 - Curtail fundraising costs
 - Limit excessive capital accumulation
 - Ensure significant resources devoted to charitable purposes and activities
- DQ introduced in 1976
- Significant reforms in 1984, 2004, 2010
- 2004 reform - became more complex
- 2010 reform – simplified DQ

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C. PRE-2010 FEDERAL BUDGET DQ RULES

- 80% DQ and 3.5% DQ
 - A charity must spend each year on charitable activities (including gifts to other charities) what is at least equal to 80% DQ + 3.5% DQ
 - Failure to meet DQ is grounds for revocation

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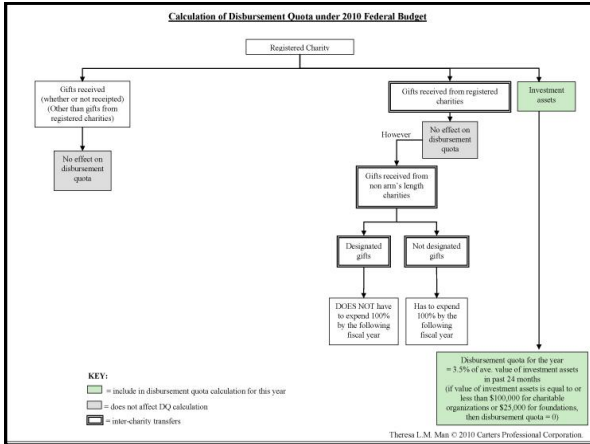
- 80% DQ (charitable expenditure rule)
 - 80% of gifts received in the immediately preceding year (except gifts of enduring property and gifts received from other charities)
 - 80% of enduring property expended in the year and 100% of enduring property transferred to qualified donees in the year (less optional reduction by realized capital gains on enduring property)
 - 80% of gifts received from other charities (except specified gift or enduring property) (100% for private foundations)

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- 3.5% DQ (capital accumulation rule)
 - 3.5% of assets not used directly in charitable activities or administration (investment assets)
 - Based on the average value of assets in 24 months immediately preceding the taxation year
 - 3.5% DQ does not apply to charities with investments \$25,000 or less
 - Detailed calculation in Income Tax Regulations 3700, 3701, and 3702

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E. 2010 BUDGET NEW DQ RULES

- March 4, 2010 federal budget
- August 27, 2010 draft ITA amendments
- September 28, 2010 Notice of Ways and Means Motions
- Received Royal Assent December 15, 2010 (Bill C-47)
- Effective for fiscal years that end on or after March 4, 2010
- Finance will monitor effectiveness of CRA's Fundraising Guidance and take further action if necessary

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1. Repeal of capital expenditure rule
 - Repealed 80% DQ
 - Repealed 80% DQ related concepts
 - Enduring property (including ten-year gifts)
 - Capital gains pool
 - Specified gifts
2. Modification of capital accumulation rule
 - Increased threshold for 3.5% DQ to \$100,000 for charitable organizations (remains at \$25,000 for foundations)
 - Purpose – reduce compliance burden on small charitable organizations and provide them with greater ability to maintain reserves to deal with contingencies

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- 3. Expansion of anti-avoidance rules
 - In relaxing the disbursement requirements by charities, the 2010 Budget extended anti-avoidance provisions
 - To cover situations where it can reasonably be considered that a purpose of a transaction was to delay unduly or avoid the application of the disbursement quota
 - Two changes introduced

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- a) Non-arm's length inter-charity gifts
 - New provision to ensure that amounts transferred between non-arm's length charities will be used to satisfy the DQ of only one charity
 - Transferee charity must expend the entire amount by the end of the following fiscal year
 - Referred to as the "immediate disbursement requirement" in the 2010 Budget
 - This expenditure is in addition to transferee's normal 3.5% DQ

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- Exception – if transferor charity elects the gift to be a "designated gift" in its T3010
 - No disbursement requirement on transferee
 - Transferor cannot use the gift to meet its own 3.5% DQ
- Failure may result in 110% penalty or revocation

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- b) Transactions to avoid or unduly delay charitable expenditure
 - Paragraphs 149.1(4.1)(a) &(b) previously permitted
 - revocation of a transferor charity that made an inter-charity gift if it could reasonably be considered that one of the main purposes of the gift was to unduly delay charitable expenditure
 - revocation of the recipient charity if it could reasonably be considered that its acceptance of the gift was an act in concert with the transferor charity

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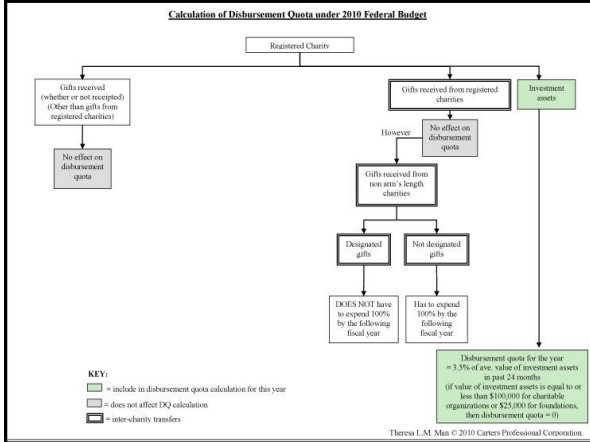
- Expanded to include situations where a registered charity entered into a transaction (which may include an inter-charity gift) where it “may reasonably be considered that a purpose of the transaction was to avoid or unduly delay the expenditure of amounts on charitable activities”
- Regardless of whether the two charities are at arm’s length
- 110% penalty
- If inter-charity transfer, both charities are jointly and severally, or solitarily liable for the penalty
- Both charities risk revocation

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- 4. Accumulation of property
 - Charities can apply to CRA to accumulate property for a particular purpose, e.g., a building project
 - Old rules - property accumulated (and income earned) with CRA approval was deemed to have been spent on charitable activities
 - New rules - accumulated property is excluded from 3.5% DQ asset base calculation

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F. CRA's ACTION

- March 31, 2010 - Message from the Director General
- April 27, 2010 - Line-by-line instruction sheet released on how to complete the current T3010B form for charities with a fiscal period ending on or after March 4, 2010
- May 3, 2010 - CRA released a list of 15 questions and answers on new DQ rules
- May 4, 2010 - new CRA webpage
- January 18, 2011 – CRA released new Form T3010-1 and Guide T4033-1 to be used for fiscal periods ending on or after March 4, 2010
- CRA will continue to provide updated information

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G. IMPLICATIONS OF NEW DQ RULES

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

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- Increase of \$100,000 threshold for charitable organizations allows greater ability to maintain reserves to deal with contingencies
- No need to track receipted vs non-receipted gifts for DQ purposes
- No need to track 10-year expiration for 10-year gifts
- Greater freedom to structure endowments and long-term gifts with donors
- Increased ability to balance long-term financial stability with flexibility to meet changing economic conditions

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

- Non-arm's length inter-charity gifts will need to be carefully structured
- Transferee must disburse the entire amount by following year, unless a "designated gift"
- When to "designate" a gift?
 - If gift could not be expended by transferee by the following year
 - Transferor charity has sufficient other charitable expenditures to meet its own 3.5% DQ
- Can designate a portion of an inter-charity transfer (CRA document 2010-0370841E5)
- Transferor charity to designate gift in its T3010-1
- Document the transfer, e.g., MOU, letters

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- Concerns
 - Meaning of "fair market value of the property" and how it is to be calculated
 - Term "designated gift" commonly used by charitable sector in other contexts – may lead to confusion
 - Prevents the transfer of endowments between non-arm's length charities, e.g.
 - hospital and parallel foundation
 - operating charity and asset holding charity for asset protection purposes

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- Meaning of “non-arm’s length”
 - Subsection 251 of the ITA provides a set of rules that determine what arm’s length means
 - However, jurisprudence and CRA’s administrative policy are mostly in the share capital context
 - Question of fact (CRA document 2010-0373181C6, October 8, 2010), factors:
 - whether there is a common mind which directs the bargaining for both parties to a transaction
 - whether the parties to a transaction are acting in concert without separate interests
 - whether there is a “de facto” control

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- Lack of tax policy rationale for immediate disbursement requirement
- Report designated gifts on Form T1236, Qualified Donees Worksheet / Amounts Provided to Other Organizations

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3. Avoidance transactions

- Expanded to include situations where a registered charity 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”
- Concerns
 - Broad meaning of “transaction”, “avoid or delay unduly” and “expenditure”
 - Donor making an endowed gift?
 - Inter-charity transfer of endowment?
 - Question of fact (CRA document 2010-0370841E5, September 24, 2010)

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- Lowered threshold of application – “a purpose” of the transaction (not one of the main purposes)
- Requires careful examination of every aspect of a transaction to ensure no unintentional purpose to avoid compliance

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4. Charitable Expenditure

- Even though the 80% DQ is repealed, charities are still required to devote their resources to charitable purposes/activities
- Concern that charities are left with this general requirement, with no objective standard to measure compliance

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5. CRA's Fundraising Guidance

- With 80% DQ repealed, more focus on compliance with CRA's Fundraising Guidance
- 2010 Budget indicates that part of CRA's Fundraising Guidance has strengthened CRA's ability to ensure that a charity's fundraising practices are appropriate
- Released June 11, 2009
- Regulates fundraising practices
- Regulates fundraising costs

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- Fundraising ratio: fundraising costs to fundraising revenue in a fiscal year
 - 35% or less - unlikely to generate questions or concerns
 - 35 to 70% - CRA will examine average ratio over recent years to determine if there is trend of high fundraising costs
 - Over 70% - will raise concerns with CRA and will likely result in revocation

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- Guidance provides information on current treatment of fundraising under ITA and common law (not a new CRA policy position) on
 - Distinguishing between fundraising and other expenditures
 - Allocating expenditures for T3010 reporting
 - Dealing with activities that have more than one purpose
 - Understanding how CRA assesses what is acceptable fundraising
- Fundraising expenditure cannot be used to meet 3.5% DQ

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- Concerns:
 - Set out in 2 separate documents rather than one consolidated document
 - Many evaluating factors used by CRA are subjective
 - Implied that charities expected to adopt “best practices” and avoid “areas of concern”
 - Level of required disclosure not clear
 - Calculation of fundraising ratio on fiscal year basis, rather than rolling average
 - Non-application of fundraising ratio to revenue received from other charities

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- Uncertain how applies to charities whose purpose is to raise funds and support other qualified donees
- Application to charities operating lotteries governed by Provincial Gaming Commissions
- CRA auditors may not be adequately versed about the Fundraising Guidance

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6. Allocation of expenses

- Only charitable expenses qualify to meet 3.5% DQ
- Still have to allocate expenses into different categories: charitable, administration, fundraising, political and business
- Difficulty to allocate expenses remains
- Already sufficient transparency – financials and generally accepted accounting principles

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7. DQ excess and shortfall

- DQ excess can be carried forward 5 years and back 1 year to meet DQ shortfall
- Anticipated many occasions where charities would have DQ excess rather than DQ shortfall
- Possible to have large DQ surplus? Example:
 - \$1 million investment assets
 - 3.5DQ = \$35,000
 - \$250,000 donations, assume \$250,000 charitable expenditure
 - DQ excess = \$215,000 to carry forward
 - 3.5 DQ for next 5 years = \$175,000

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8. Accumulation of property

- Once CRA's permission granted, property accumulated excluded from asset base in calculating 3.5% DQ
- What to do with outstanding CRA permission to accumulate property?
- Anticipated to be fewer occasions to seek CRA's approval to accumulate property

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9. DQ reduction

- Possible for charity to incur DQ shortfall for reasons beyond its control
- May apply to CRA for reduction in DQ – usually only granted in extraordinary circumstances
- With repeal of 80% DQ, anticipated that there will be fewer occasions that require seeking DQ reduction.

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10. New endowments and long term gifts

- No need to struggle with structuring long-term gifts or endowment funds to comply with complex ITA language related to enduring property
- Flexibility in structuring new gifts – can focus on balancing:
 - Donor desires for long-term financial stability
 - Need for flexibility to meet changing economic conditions

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- Encroachment
 - Ability to encroach on capital?
 - Discuss with donor under what circumstances
- Income and capital
 - Maybe remove reference to income and capital
 - Use total return investment and payout strategy instead
- Length of hold period
 - 10 year is no longer a “magic number”
 - Discuss with donor appropriate length
 - May be “long term” rather than perpetuity

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- Other gifting issues to discuss with donor, e.g., payout strategies, investment strategies, administrative fees, donor advice, variance clause, flexibility, etc.
- Revise template gift documents to remove reference to enduring property, 10-year gifts, capital gains pool etc.; more flexible terms
- Revise internal policies, e.g., gift acceptance policies, endowment fund policies, etc.
- Revise publications, e.g., website, promotion materials, donor communications, etc.
- Educate donors and staff

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11. Existing Endowments

- What to do with existing endowment funds, long-term gifts and ten-year gifts?
 - Many endowment agreements provide for distribution of income but no right to encroach on the capital
 - Generally no right to vary the agreement
 - Many endowments provide for hold on expenditure of capital because of pre-budget DQ rules
- Questions
 - Can capital be encroached?
 - Still need to track 10-year period?
 - Still need to track hold period?

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- Must review documents
 - Existing gift agreements and donors' directions
 - Constatng documents – letters patent/special Act/by laws
 - Internal policies relating to spending, distribution of funds, investment policies
 - External publications for fundraising or reporting or other communications
- Must also review regulatory context
 - Federal – Income Tax Act
 - Provincial - Jurisdiction over charitable property and common law
 - Trust law - common law

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- What to review:
 - Terms of gifts
 - What restrictions
 - On investments
 - On expenditure of income or capital
 - For what purpose
 - Timing of expenditure
 - Who imposed the restrictions
 - Donor
 - Board of charity
 - If can expend income but not capital
 - What does income mean
 - What does capital mean

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- Must identify what type of fund
 - Endowments
 - Restricted funds
 - Unrestricted funds
 - Precatory Gifts – donor advised funds
- If endowments
 - If holding period or other restriction is set by donor at time of gift: trust law considerations
 - If holding period or other restriction set by the Board: may be able to be changed by the board

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- If gift is a trust
 - Trust terms must be complied with and any failure to do so constitutes breach of trust
 - Donor cannot vary terms of trust unless power expressly reserved at time trust is settled
 - Thus charity cannot encroach on capital if terms of trust do not permit encroachment

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- Can agreements be amended?
 - *Cypres* court order to vary terms
 - If terms impractical or impossible
 - *Re Killam Estate* (1999) 38 ETR (2d)142
 - *Stillman* case (2003) 68, OR (3d) 777 (SCJ)
 - Terms of charitable trusts were varied to permit total return investment policy and capital encroachment based on % of value of the assets
 - In Ontario s. 13 *Charities Accounting Act* provides a summary process – PGT involved

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- If restrictions in constating documents
 - If constating document is a trust (inter vivos or testamentary), check to see whether power to vary and if so the scope of the power and the process for variation
 - If constating document is letters patent, follow procedure for amending letters patent in the applicable corporate statute. In Ontario PGT may require that donations received while restrictions in letters patent continue to have those restrictions apply to existing endowments

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12. Corporate Sponsorships

- To receipt or not to receipt?
- No 80% DQ concerns if receipted
- But receipt should not include fmV of marketing/advertising value received by sponsor


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H. CONCLUSION

- Welcomed change
- Simplicity of DQ calculation
- Still many unanswered questions
- Needs CRA clarification
- CRA Fundraising Guidance will be key

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