Ins and Outs of the Increased Disbursement Quota

By Theresa L.M. Man, B.Sc., M.Mus., LL.B., LL.M.

tmancarters.ca
1-877-942-0001

CARTERS
Integrated Practice, Proactive Advice

Carters/Fasken Healthcare Philanthropy Webinar 2024

February 13, 2024

Ins and Outs of the Increased Disbursement Quota

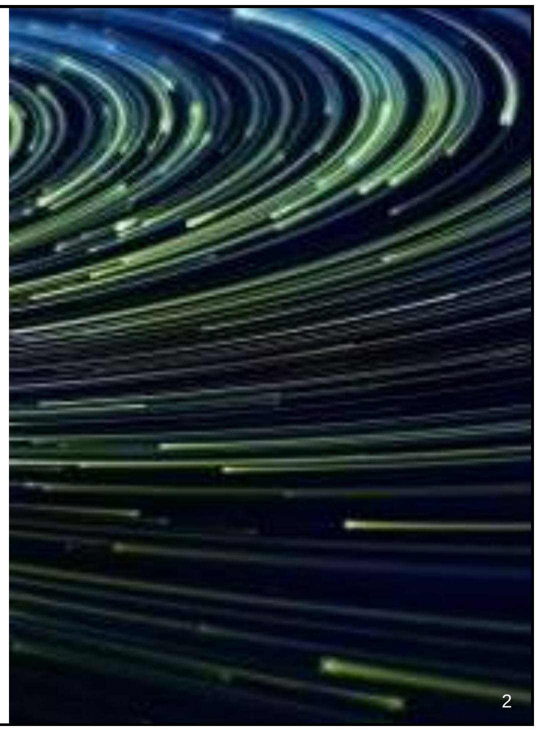
By Theresa L.M. Man, B.Sc., M.Mus., LL.B., LL.M.
tman@carters.ca

Carters Professional Corporation
Lawyers & Trademark Agents

Orangeville • Ottawa • Toronto
www.carters.ca **Toll Free: 1-877-942-0001**

Overview

- What is Disbursement Quota
- Timeline of DQ
- New changes to DQ on January 1, 2023
- DQ Rate
- Calculate DQ obligation
- Meet DQ obligation
- Track DQ shortfall and excess
- Track DQ in T3010s
- DQ obligation reduction
- Accumulation of property
- Administration and management expenses
- Comply anti-avoidance rules
- Challenge to meet 5% DQ



www.carters.ca 2

What is the Disbursement Quota?

- Disbursement Quota ("DQ") is the minimum amount that a charity must spend on its charitable activities or qualifying disbursements (including gifts to qualified donees and grants to non-qualified donees)
- DQ is to ensure that charitable funds are used for charitable purposes and are not simply accumulated indefinitely by charities
- A requirement under the *Income Tax Act* ("ITA")
- DQ applies to all charities but is of particular relevance to foundations and other healthcare charities that have investment assets that are not being used directly in charitable activities or administration (such as endowments or portions of buildings that are surplus and are rented out)

Timeline of DQ

1976
DQ first introduced

1984
Significant DQ Reform, including 4.5% DQ applying to public & private foundations

2004
DQ Reform saw rate reduced from 4.5% to 3.5%, but extended to charitable organizations

2010
DQ Reform exempts ≤$100,000 (charitable organizations) or ≤$25,000 (foundations) from DQ

April 19, 2021
Budget 2021 proposes public consultation to increase DQ

August 6 – December 2, 2021
Department of Finance holds DQ consultation

April 7, 2022
Budget 2022 proposes increase in DQ from 3.5% to 5% for amounts over $1M

June 23, 2022
BIA No. 1 in force, gifts that are qualifying disbursements satisfy DQ

August 9, 2022
Draft legislation proposes changes to DQ, including increase to 5% for amounts over $1 M

December 15, 2022
Bill C-32 *Fall Economic Statement Implementation Act, 2022, received Royal Assent* increasing the DQ rate

New Changes to DQ on January 1, 2023

- As a result of sector wide consultations in 2021, the 2022 Federal Budget announced that DQ would be increased to 5% for amounts in excess of $1 million
- *Economic Statement Implementation Act, 2022 ("Bill C-32") received Royal Assent* on December 15, 2022
- Amended the ITA to increase the DQ rate from 3.5% to 5% for property held by a charity in excess of $1 million that is not used directly in charitable activities or administration
- Increased DQ applies to taxation years beginning on or after January 1, 2023

DQ Rate

Charitable organizations with average value exceeding $100,000 or foundations with average value exceeding $25,000, DQ is 3.5% for property up to $1 million, and 5% for property over $1 million

Type of Charity and Value of Property* held by the Charity		DQ Obligation	
Charitable Foundation	**Charitable Organization**		
with ≤$25,000 of property	with ≤$100,000 of property	Nil	
With >$25,000 and ≤$1,000,000 of property	with >$100,000 and ≤$1,000,000 of property	3.5% of property	
with >$1,000,000 of property	with >$1,000,000 of property	OLD RULE **Before Jan. 1, 2023** 3.5% of property	NEW RULE **Starting Jan. 1, 2023** $35,000 + 5% of property exceeding $1,000,000

- "property" refers to the average value of property owned by the charity in the preceding 24 months that is not used directly in charitable activities or administration as determined under sections 3701 and 3702 of the Regulations

Calculate DQ Obligation

- Rules are set out in the ITA, detailed calculation in Income Tax Regulations 3700, 3701, and 3702

1. Property to be included - Property not used directly in charitable activities or administration of the charity
   - For example - cash, investments, inventory, stocks, bonds, mutual funds, GICs, land, and buildings
   - If permission was granted by CRA on or before December 31, 2022 to accumulate funds, the accumulated amount is excluded from the asset base
2. Time frame – DQ calculation applies for the preceding 24 months (i.e., the 24 months immediately preceding the taxation year)
   - For example, assume year end Dec 31, then DQ for 2022 is based on Jan. 1, 2020 to Dec. 31, 2021

3. Calculate average value in time frame – determine the "average value" of the property of the 24 month period by over 2 to 8 periods
   - Charity to choose number of periods to calculate the "average value" of the property
   - To be chosen when the charity files its first information return
   - Future changes of the number of periods requires CRA approval

	Jan. 1 to Dec. 31, 2022	**Jan. 1 to Dec. 31, 2023**	**Current fiscal year Jan. 1 to Dec. 31, 2024**
Example of # of periods	24 months before the fiscal year in question		Calculate DQ 3.5% or 5% on the base value
2 periods (*i.e.* annually)	FMV as of Dec. 31, 2022	FMV as of Dec. 31, 2023	Add the 2 FMV numbers and divide by 2
4 periods (*i.e.* semi- annually)	FMV as of June 30 and Dec. 31, 2022	FMV as of June 30 and Dec. 31, 2023	Add the 4 FMV numbers and divide by 4
8 periods (*i.e.* quarterly)	FMV as of Mar. 31, June 30, Sep. 30, Dec. 31 2022	FMV as of Mar. 31, June 30, Sep. 30, Dec. 31, 2023	Add the 8 FMV numbers and divide by 8

Meet DQ Obligation

Only these expenditures can be used to meet the DQ obligation
- Funds spent by a charity on its charitable activities
- Qualifying disbursements on gifts to qualified donees and grants to non-qualified donees

New qualifying disbursements rules provide that qualifying disbursements are disbursements "by way of a gift or by otherwise making resources available"
- Does not appear "making resources available" will satisfy the DQ, as only gifts will count
- See Terrance Carter's presentation on qualifying disbursements

Global calculation
- Calculate at charity level, not specific asset level – *i.e.*, not restricted to spending 3.5% or 5% of the assets constituting the DQ asset base, all charitable disbursements can be used to meet the DQ
- Sometimes referred to "global" calculation

Track DQ Shortfall and Excess

DQ Excess
- Occurs when a charity spends more on charitable activities or qualifying disbursements than its DQ for that year
- Excess can be carried forward for 5 years or carried back 1 year

DQ Shortfall
- Occurs when a charity spends less on charitable activities or qualifying disbursements than its DQ for that year
- Shortfall can be met using excess from past 5 years or from next year
- Continuous shortfalls may lead to revocation of a charity's registration

Track DQ in T3010s

Track DQ in T3010s

- Charities need to ensure that they properly and fully complete the DQ portion of the T3010 and that they meet their annual DQ obligation
- CRA released version 24 of Form T3010, *Registered Charity Information Return*, ("Form T3010") on January 8, 2024 – to be used for fiscal year ending on or after December 31, 2023 or later

- **Line 5900** - average value of property not used directly in charitable activities or administration during the 24 months before the <u>beginning</u> of the fiscal period - This is used to calculate the DQ obligation for the <u>current</u> fiscal
  - For example – if T3010 is for fiscal Jan . 1 to Dec. 31, 2024, then line 5900 is for period Jan. 1, 2022 to Dec. 31, 2023
- **Line 5910** – average value of property not used directly in charitable activities or administration during the 24 months before the <u>end</u> of the fiscal period - This is used to calculate the DQ obligation for the <u>next</u> fiscal
  - For example – if T3010 is for fiscal Jan. 1 to Dec. 31, 2024, then line 5910 is for period Jan. 1, 2023 to Dec. 31, 2024

2022 fiscal	2023 fiscal	T3010 for 2024 fiscal
Line 5900 in T3010 for 2024 – FMV for this 24 month period - To calculate DQ for 2024 fiscal		
	Line 5910 in T3010 for 2024 – FMV for this 24 month period - To estimate DQ for 2025 fiscal	

- New Question 17 and Schedule 8 to track DQ
- **Question 17 (and line 5850)** – asks if the charity has average value of property not used directly in its charitable activities or administration exceeding $100,000 if the charity is a charitable organization, or exceeding $25,000 if the charity a public or private foundation
- If so, then their DQ rate is not nil (see table above), and it has to complete Schedule 8
- **Schedule 8** has 2 Steps
  - Step 1 calculates the DQ obligation for the fiscal year the charity is reporting, and whether the DQ is met
  - Step 2 calculates the estimated DQ obligation for the next fiscal year in order that the charity can plan ahead

DQ Obligation Reduction

- CRA has discretion to grant a reduction in a charity's DQ obligation for any particular tax year
- A DQ reduction is available to charities whose expenditures on charitable activities or qualifying disbursements were less than required in the year due to circumstances beyond their control, thus causing the charity to incur a spending shortfall and not meet its DQ obligation
- Before Bill C-32, subsection 149.1(5) of the ITA allowed the CRA to deem a specified amount expended by a charity to be an amount expended by a charity on its own charitable activities in satisfaction of the DQ
- Bill C-32 amended subsection 149.1(5) to allow the CRA to instead deem a charity's DQ obligation to be reduced upon application by the charity

- CRA's policy
  - Purpose of a DQ reduction is an alleviating provision to allow a charity to correct a deficiency in meeting its DQ when the deficiency is the direct result of special circumstances beyond the charity's control that are specific and not general in nature
  - This is not to be used as a mechanism to exempt the charity from meeting its DQ, except in extraordinary circumstances
  - A reduction will only be considered once the charity has exhausted all other available means to make up the shortfall
  - The earliest that a charity can receive approval for a DQ reduction is after CRA has issued a Registered Charity Information Return Summary for the fiscal period following the period in which the shortfall occurred
- Bill C-32 also amended the ITA to allow the CRA to release information to the public pertaining to a charity's application to reduce its DQ obligation, under s. 241(3.2) of the ITA

- Use Form T2094 - *Registered Charities: Application to Reduce Disbursement Quota* to apply for a DQ reduction
- If CRA grants DQ reduction, the charity must amend the T3010 return for the fiscal period in which the shortfall occurred to include the approved amount on line 5750 – Use Form T1240, *Registered Charity Adjustment Request*

Accumulation of Property

- This refers to approvals granted by CRA to exclude accumulated property from the DQ calculation before December 31, 2022
- Before January 1, 2023, a registered charity could request approval from CRA to exclude accumulated property from its DQ calculation
  - This allowed a charity to set aside significant funds for specific qualifying activities without incurring a divestment obligation during the accumulation period
  - If a charity was granted written approval to accumulate property before January 1, 2023, the approval is still valid under the terms indicated until the approved period expires
  - But CRA will not grant extensions to the approved period
- Starting January 1, 2023 - Bill C32 repealed s. 149.1(8), CRA no longer reviews or grant accumulation requests. Charities must include all assets not directly used in charitable programs or administration in their DQ calculation

Administration and Management Expenses

- Bill C-32 added paragraph (d) to subsection 149.1(1.1) of the ITA to provide that administration and management expenditures are deemed not to satisfy the disbursement quota requirements
- CRA has not provided guidance about how charities should calculate which expenditures are used in administration & management of the charity
- Many unanswered questions, for example:
  - Can amounts be allocated on a percentage basis, similar to fundraising expenses?
  - For example - if an employee spends 90% of time engaged in carrying out charitable activities and 10% doing administrative work, is substantially all of the work charitable for purposes of the DQ, as is the case with fundraising expenses?

Comply Anti-avoidance Rules

Rule #1 - Charities must comply with anti-avoidance rules on gifts between non-arm's length charities - to ensure amounts transferred between non-arm's length charities will be used to satisfy the DQ of only one charity

1. Anti-Avoidance Rule

- When a gift is received from a non-arm's length charity, the recipient charity must disburse the entire gift in the fiscal period the gift was received or in the following fiscal period by spending the amount on
  - Own charitable activities
  - Qualifying disbursements to qualified donees or grantee organizations with which it deals at arm's length
- Failure to do so could result in a 110% penalty on the unexpended amount or the revocation of the receiving charity's charitable status

2. Designated Gift

- To avoid 100% expenditure under the anti-avoidance rule, the donor charity may designate that the gift is a "designated gift" - so that
  - The gift is not counted in meeting the donor charity's own DQ obligation
  - The recipient charity does not have to spend 100% of the designated gift by the end of the next fiscal period
  - If the recipient charity does not use the designated gift in its charitable activities or administration, it will form part of the DQ asset base

- To designate a gift, the donor charity must indicate the gift is a designated gift in its T3010 for the fiscal period in which the gift is made by:
  - Answering yes to Question C3 (line 2000) in T3010
  - Not including the designated gift in line 5050 when reporting total amount of gifts to qualified donees (therefore cannot be used to meet its DQ obligation)
    - See T4033 Guide
    - But T3010 form does not say to exclude designated gift in line 5050
  - Reporting the gift in Form T1236, *Qualified Donees Worksheet / Amounts Provided to Other Organizations*
    - Writing on the blank line below the amount of non-cash gifts, write "designated gift“ - See CRA webpage https://www.canada.ca/en/revenue-agency/services/charities-giving/charities/operating-a-registered-charity/receiving-gifts/anti-avoidance-rules-designated-gifts.html
    - This instruction is not in T4033 Guide or Form T1236

Example

- Charity A and Charity B are non-arm’s length
- Charity A transfers $100,000 to Charity B = this is an inter-charity gift

	Charity A	Charity B
Anti-Avoidance Rule	$100,000 gift is counted toward meeting A’s 3.5% DQ obligation	B must spend the entire $100K by the following fiscal year
Designated Gift Exception	• A designates in its T3010 the $100,000 is a “designated gift” • The $100,000 does not go towards meeting A’s 3.5% DQ obligation	• B can keep the $100,000 and spend it anytime it wants • If B does not use the $100,000 in its charitable activities or administration, then it will form part of the DQ asset base

Rule #2 - Even where charities are arm's length, charities must comply with a broader anti-avoidance rule

- A charity that enters 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" could face a 110% penalty or possibly revocation
- See paragraph 149.1(4.1)(a) of the ITA
- The concept of a "transaction" may now include qualifying disbursements, which would include "otherwise making resources available"
- If an inter-charity transfer is involved, both charities are jointly and severally, or solitarily liable for the 110% penalty and risk revocation

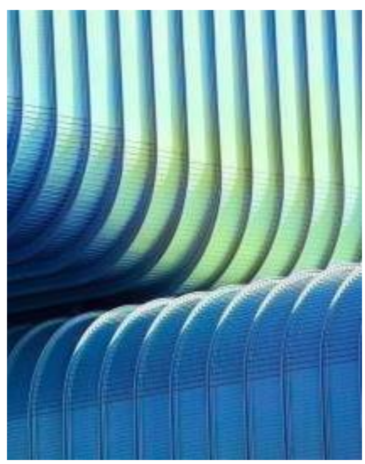
Challenge to Meet 5% DQ

For charities, and in particular, foundations, with endowments or other funds that have restrictions concerning how or when capital can be expended, it may be difficult to meet a 5% DQ with only income generated from the investment available for disbursements

Charities may need to apply to court for an order granting permission to encroach on the capital or realized capital gains of an endowment

Unfortunately, court applications can be costly and time consuming and success is not guaranteed

Difficulty meeting the DQ may prompt charities to possibly pursue riskier investments to obtain a higher rate of return. This might be contrary to their fiduciary obligations under provincial *Trustee Act* legislation



TAKE AWAYS

DQ rules are complicated

Important for charities to carefully track the DQ obligation and ensure that it is met

Challenges for charities with endowments to meet 5% DQ

Challenges to determine what is an eligible qualifying disbursement to meet DQ

Properly and fully complete the DQ portion of the T3010 – prudent to seek legal review of draft T3010 and obtain board approval

RESOURCES

- Terrance S. Carter, Jacqueline M. Demczur & Theresa L. M. Man, "Complexities of the Disbursement Quota Calculation: More Than Just a Number" *Charity & NFP Law Bulletin No. 498*, 25 August 2021 https://www.carters.ca/pub/bulletin/charity/2021/chylb498.pdf
- Terrance S. Carter & Theresa L.M. Man, "Reminder for Charities to take the Necessary Steps to Meet the DQ" *Charity & NFP Law Bulletin No. 507,* 24 February 2022 https://www.carters.ca/index.php?page_id=456
- Terrance S. Carter, "Disbursement Quota Reform: Stabilizing a Three-Legged Stool" *Perspectives on Tax Law & Policy*, vol 3, no 1, March 2022 https://www.ctf.ca/CTFWEB/EN/NEWSLETTERS/PERSPECTIVES/2022/1/220106.aspx
- Terrance S. Carter, Theresa L.M. Man & Jacqueline M. Demczur, "Draft Budget Implementation Legislation Will Increase DQ and Affect Trust Reporting" *Charity & NFP Law Bulletin No. 515*, 24 August 2022 https://www.carters.ca/index.php?page_id=520
- Terrance S. Carter, Theresa L.M. Man & Jacqueline M. Demczur, "Bill C-32 Will Increase DQ, Affect Trust Reporting, and Make Other Changes to the Income Tax Act" *Charity & NFP Law Bulletin No. 517*, 23 November 2022 https://www.carters.ca/index.php?page_id=554

Theresa L.M. Man, B.Sc., M.Mus., LL.B., LL.M. – A partner with Carters, Ms. Man practices in the area of charity and not-for-profit law, is ranked by *Lexpert*, *Best Lawyers in Canada*, and *Chambers and Partners*, and received the 2022 OBA AMS/John Hodgson Award of Excellence in Charity and Not-For-Profit Law. She is a co-author of *Corporate and Practice Manual for Charitable and Not-for-Profit Corporations* published by Thomson Reuters. She is a former member of the Technical Issues Working Group of the CRA Charities Directorate, a member and former chair of the CBA Charities and Not-for-Profit Law Section and the OBA Charities and Not-for-Profit Law Section. Ms. Man has also written on charity and taxation issues for various publications.

Contact information: tman@carters.ca
1-877-942-0001

Disclaimer

This handout is provided as an information service by Carters Professional Corporation. It is current only as of the date of the handout and does not reflect subsequent changes in the law. This handout is distributed with the understanding that it does not constitute legal advice or establish a solicitor/client relationship by way of any information contained herein. The contents are intended for general information purposes only and under no circumstances can be relied upon for legal decision-making. Readers are advised to consult with a qualified lawyer and obtain a written opinion concerning the specifics of their particular situation.