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University of Western Ontario Faculty of Law - Introduction to Charity and Not-For-Profit Law
January 17, 2022

DISBURSEMENT QUOTA REFORM: YESTERDAY, TODAY AND TOMORROW

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

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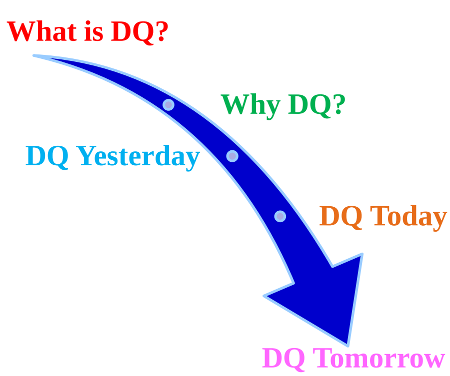
OVERVIEW



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1. What is DQ? And Why DQ?

- "Disbursement quota" (DQ) is the minimum amount that a charity must spend on its charitable activities or gifts to qualified donees to ensure that charitable funds are used for charitable purposes and are not simply accumulated indefinitely by charities
- Requirement under the *Income Tax Act*
- Purpose of DQ
  - Limit excessive or undue capital accumulation
  - Ensure significant resources devoted to charitable purposes and activities
  - Administrative efficiency – via increased transparency/disclosure
  - Curtail fundraising costs

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2. DQ – Yesterday (before 2010 reform)

- First introduced in 1976
- Significant reforms in 1984, 2004, 2010
- 2004 reform – rules became more complex
- 2010 reform – simplified DQ = current rules

For details, see Theresa L. M. Man, 2011 National Charity Law Symposium "Disbursement Quota Reform: The Ins and Outs of What You Need to Know" (6 May 2011)
https://www.carters.ca/pub/article/charity/2011/tlm0506.pdf

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Rules before current rules (before 2010)

- 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
- Complicated rules for 80% DQ
- 3.5% was reduced from 4.5% in 2004 because
  - Interest rates were “low” at the time
  - Many charities were struggling to meet 4.5% DQ
  - 3.5% DQ was more representative of historical long-term real rates of return earned on the typical investment portfolio held by a registered charity

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Calculation of Disbursement Quota under Bill C-33

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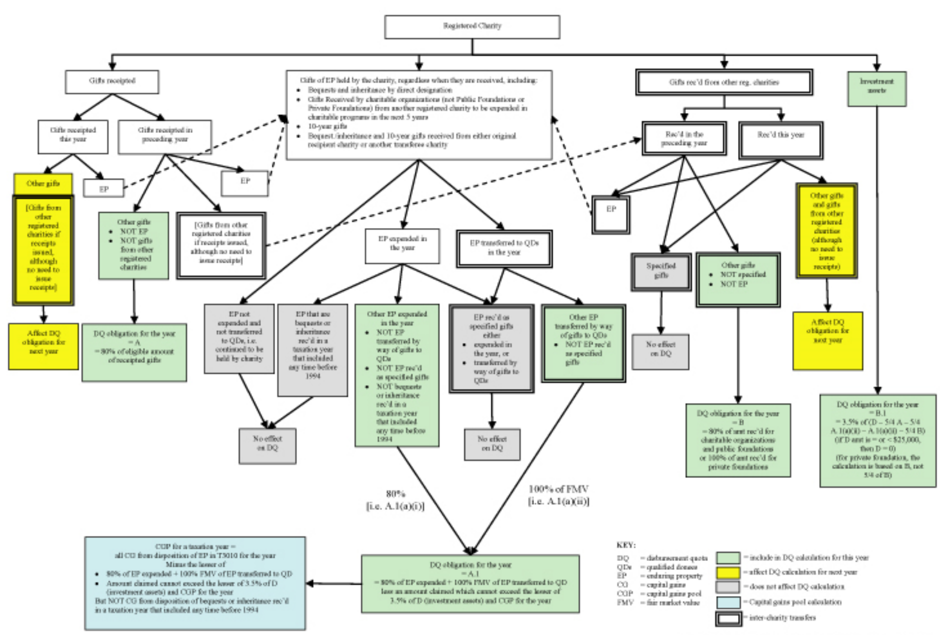

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3. DQ – Today (2010 reform)

- 2010 Federal Budget greatly simplified DQ rules
- Effective for fiscal years that ended on or after March 4, 2010
- Greatly simplified the DQ rules

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Calculation of Disbursement Quota under 2010 Federal Budget

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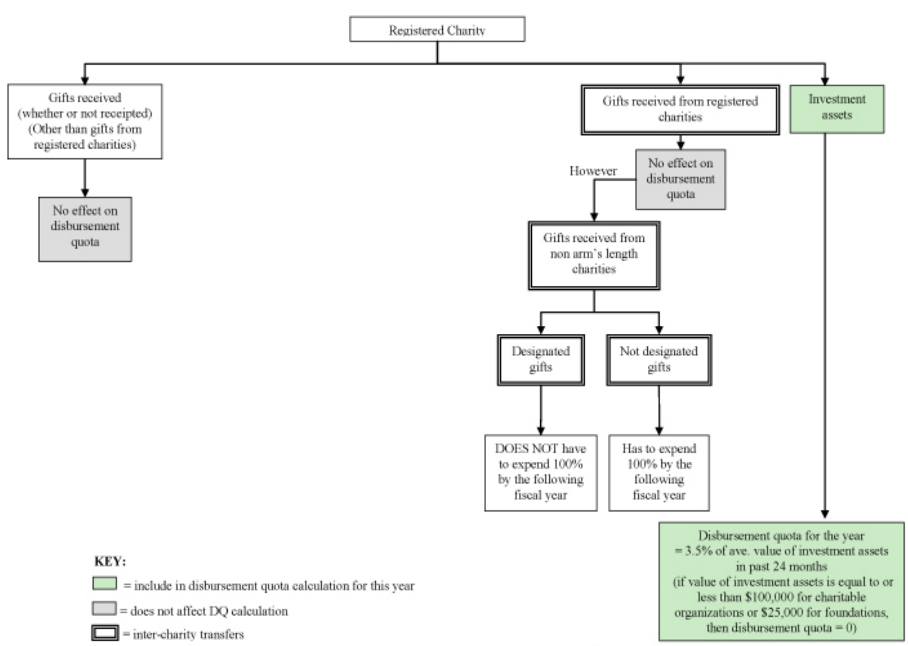

1. Repealed 80% DQ and related concepts - such as enduring property (including ten-year gifts), capital gains pool, specified gifts
2. Modified 3.5 DQ rule

- 3.5% of assets not used directly in charitable activities or administration of the charity in past 24 months
- 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
- ITA - Detailed calculation in Income Tax Regulations 3700, 3701, and 3702

- Asset base - assets not used directly in charitable activities or administration of the charity – e.g. cash, investments, inventory, stocks, bonds, mutual funds, GICs, land, and buildings
- Time frame – assets in 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
- Average value in time frame - “Average value” is based on dividing 24 months into 2 to 8 periods (to be chosen when the charity files its first information return, and requires CRA approval to change it later)

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Example

	Jan 1 to Dec 2020	Jan 1 to Dec 2021	Current fiscal year Jan 1 to Dec 2022
Example of # of periods	24 months before the fiscal year in question		What is 3.5% DQ?
2 periods (ie annually)	Fmv as of Dec 31 2020	Fmv as of Dec 31 2021	Add the 2 fmv numbers and divide by 2
4 periods (ie annually)	Fmv as of June 30 and Dec 31 2020	Fmv as of June 30 and Dec 31 2021	Add the 4 fmv numbers and divide by 4
8 periods (ie quarterly)	Fmv as of Mar 31, June 30, Sep 30, Dec 31 2020	Fmv as of Mar 31, June 30, Sep 30, Dec 31 2021	Add the 8 fmv numbers and divide by 8

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- How to meet 3.5% DQ
  - Only funds spent by a charity on its charitable activities or gifts to qualified donees are qualified to meet the 3.5% DQ
  - At charity level, not asset level – i.e., not restricted to spending 3.5% from the assets forming the DQ asset base, all charitable disbursements can be used to meet the DQ [sometimes referred to “global” calculation]

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Example – charitable organization has the following assets

$1million in investments (GIC)

- Assume rough 3.5% DQ is $35,000
- Assume $1m yields 4% income = $40,000

$500,000 in current bank account for programs and admin.

- Charity spends $300,000 on charitable activities
- Charity spends $100,000 on gifts to QDs
- Total charitable expenses = $400,000, which is more than enough to meet the 3.5% DQ
- Means charity does not need to spend any of the $1 million in investment or its return to meet DQ

3. Expanded anti-avoidance rules

- In relaxing the DQ rules, anti-avoidance provisions were expanded 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

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

- New provision to ensure amounts transferred between non-arm's length charities will be used to satisfy the DQ of only one charity
- Transfer from charity A to charity B (where A and B are non-arm's length)
  - Charity A must spend the entire amount by the end of next fiscal year
  - Exception Charity A indicates in its T3010 that the transfer is a "designated gift", but Charity A cannot use the amount to meet its own 3.5% DQ obligation
- Failure may result in 110% penalty or revocation

Example -

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

	Charity A	Charity B
Normal rule	A spends $100K in gift to QD, counts toward meeting A's 3.5% DQ obligation	B must spend the entire $100K by the following fiscal year
Exception	• A designates in its T3010 the $100K is a "specified gift" • The $100K does not go towards meeting A's 3.5% DQ obligation	• B can keep the $100K and spend it anytime it wants • If B keeps $100K in its investments, then it will form part of the DQ asset base

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(b) Transactions to avoid or unduly delay charitable expenditure

- 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

5. DQ excess and shortfall

- DQ excess can be carried forward 5 years and back 1 year to meet DQ shortfall

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4. DQ Tomorrow?

April 2021 Federal Budget

- April 19, 2021 Federal Budget proposes launching public consultations to potentially increase DQ – purpose
  - To "boost" the charitable sector to increase its spending on charitable programs in their communities
  - Budget 2021 anticipates that this could possibly increase support for the charitable sector and those who rely on its services by between $1 billion and $2 billion annually.

Finance Consultation

- Department of Finance Canada launched a public consultation on August 6, 2021, and closed on December 2, 2021
- See Finance Backgrounder https://www.canada.ca/en/department-finance/programs/consultations/2021/boosting-charitable-spending-communities/backgrounder-disbursement-quota-consultation.html

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Many submissions were made, for example:

- Carters (Charity & NFP Bulletin 498)
  https://www.carters.ca/pub/bulletin/charity/2021/chylb498.pdf
- Canadian Bar Association – 2 submissions
  https://www.cba.org/CMSPages/GetFile.aspx?guid=a8cc9301-1546-4097-b9ce-c95dbd4b28fa
  https://www.cba.org/CMSPages/GetFile.aspx?guid=d792277a-1f41-4174-aa54-e2ad00a53c31
- Advisory Committee To The Charitable Sector
  https://www.carters.ca/pub/article/charity/2021/ACCS-Submission.pdf
- Imagine Canada
  https://imaginecanada.ca/sites/default/files/disbursement-quota-submission-Imagine-Canada.pdf
- Pemsel Foundation (research series)
  https://www.pemselfoundation.org/disbursement-quota-research-series/

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- **Questions**
  - How much to increase to?
    - Finance Canada's Backgrounder includes comparisons to the US and Australia where private foundations and funds have a minimum 5% disbursement requirement
    - Conservative election platform proposes 7.5%
    - Other proposals have ranged as high as 10%
- Is it simply picking a number?
- What would the new rules look like?
- Decision requires consideration of legislative and policy environment in which the DQ exists and the impact that any change in the DQ rate might have on registered charities, their stakeholders and the public in general

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Key Issues

1. Insufficient and relevant data

- Is there sufficient data to show that there is a problem and that increasing the DQ will result in more funds in the community
- Main source of information on registered charities is the T3010 annual return charities file each year on whether DQ has been met – incomplete picture
- Lack of other data on many issues, for example
  - Are the investments held by larger charities skewing the average percentage of disbursements?
  - How are charities expending their funds to meet their DQs?

2. Concerns of overly complicated compliance

- New DQ rules must be easy to understand, calculate and comply with – recall pre-2010 rules

3. Can we require DQ be met at the fund (asset) level?

- Huge administrative burden
- Some charities hold hundreds of funds
- Funds may be restricted to donors' restrictions, which may be inconsistent with new DQ disbursements requirements

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4. Need to be mindful of terms/restrictions of endowment funds held by charities

- What if endowment funds held by charities do not permit encroaching capital or realized capital gains?
  - If investment returns is less than the DQ%, can charities encroach on capital or realized capital gains?
  - Some endowments are structured by donors to prevent the charities from encroaching on capital or realized capital gains – will require court order to allow the charity to dip into capital or realized capital gains to meet DQ
  - Court applications are costly and time consuming, and no guarantee courts will grant the order sought

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5. Low investment market return

- What if investment returns is less than the DQ%?
  - Would charities be pressured to invest in high risk investments that give higher return?
  - Would this conflict with provincial prudent investment standards?
- Recall reducing the 4.5% to 3.5% in 2004 DQ reform

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6. **Releasing funds from foundations vs charitable organizations**

- If increase DQ for foundations is intended to release investments held by foundations, what about charitable organizations that also hold large investments?
- Since current rules to meet the DQ is at charity level, not fund level, would we need to require DQ be met at fund level?
- What about charitable organization that can meet its DQ without spending from its investments, do we need different rules for foundations and charitable organizations? – recall pre-2010 DQ rules

7. **Long term planning for charities**

- Would increasing the DQ to require charities to spend down on investment assets affect their ability to do long term planning?
- Would higher DQ affect the sustainability of charities?

8. **Donors intentions**

- Donor intention – what do donors what?
  - To create long term legacy by creating endowments that benefits generations to come?
  - To use wealth of this generation to benefit this generation?
- Is requiring charities to spend down on investments in conflict with donor intentions that favour creating endowments?

9. Expanding what would qualify to meet DQ obligations?

- Recall - Only funds spent by a charity on its charitable activities or gifts to qualified donees are qualified to meet the 3.5% DQ
- List of "qualified donees"? - Can we expand this?
- Disbursements on "own activities"
  - Restrictive rules, legal fiction
  - Bill S-216 to allow resources be used by third parties with accountability back to the charity

- Dual purpose investments do not count toward meeting the DQ
  - Investments that involve the dual purpose of achieving the charity's charitable purpose and seeking a financial return
  - For example - impact investments, social investments, social finance, program related investments (PRIs)

Summary

Is there a problem?

- Are charities hoarding funds and not disbursing them to meet the public need?
- Are charities which hold donor advised funds sufficiently transparent and accountable?
- Are private interests superseding the public good in determining how and when to disburse funds?

If there is an issue:

- Can increasing the DQ address these concerns?
- Are there other ways to better address these concerns?

If DQ needs to be changed – potential criteria and factors

- New rules must be easy for the sector to understand, calculate, and meet
- New rules must not create administrative burden
- New rules must not create unintended consequences
- Charities must have access to funds to meet the DQ
- Charities must have appropriate ways to meet the DQ that allow funds be disbursed in the community intended by Parliament

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