

ELIMINATING THE DISBURSEMENT QUOTA: GOLD OR FOOL'S GOLD?

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INTRODUCTION

THE FEDERAL BUDGET IN MARCH 2010¹ ANNOUNCED THE ELIMINATION OF A significant part of the disbursement quota for charitable organizations and changes to related provisions. The reform of the disbursement quota came after a substantial effort by associations representing charities, such as Imagine Canada and the Canadian Bar Association, to reform the disbursement quota. Charitable organizations and their advisors held the view that the disbursement quota had become excessively complicated, difficult to understand, too often required the retention of expensive expertise to comply, and had unfortunate impacts on charities.²

There are two major parts to the disbursement quota for charitable organizations i) the longstanding 80% rule, by which a charity was to expend at least 80% of its receipted income on charitable activities in the subsequent year, and ii) the required expenditure each year of at least 3.5% of the value of assets (greater than \$25,000) not used directly in charitable activities or administration. The disbursement quota rules for private and public foundations were similar, but – with unique variations ostensibly to reflect the characteristics of foundations – no less cumbersome.

BACKGROUND

The history of the disbursement quota is important in understanding why reform was considered necessary after 34 years of development. Notwithstanding what some may think, the disbursement quota was not designed solely for the sake of its own existence and to frustrate volunteers.

The disbursement quota was introduced in 1976. It was part of a broader reform of income tax legislation flowing from the Royal Commission on Taxation (Carter Royal Commission).³ The disbursement quota was intended to ensure that funds raised for charitable purposes were used for charitable purposes. It was introduced to curtail administrative and fundraising costs, and to limit capital accumulation.

Given that the federal and provincial governments provide a significant “tax expenditure” for receipted income, a public policy that encouraged use of funds for the purposes raised was – and remains – understandable. Indeed, John Hamilton (1985) in

The Regulation of Charities: The Ideal identifies the disbursement quota as part of a federal regulatory structure. He comments:

The regulation of registered charities after registration should be restructured so as to be much more effective than it is at present. Some of the steps which might be taken are as follows:

- (c) All charities should be required to meet a suitable disbursement quota with respect to the funds which they receive and for which they give charitable receipts and (as discussed below) possibly the net income from any business carried on by that charity. It is hoped that the method of calculating that disbursement quota might be somewhat simplified from that set out in Section 149.1(1) (e) of the present *Income Tax Act*.

It is, of course, the wise counsel in the last sentence from Hamilton that rang true in 1985 and remains true today. The absence of a simplified measure has been the fundamental problem.

If one keeps in mind the underlying public policy purpose for a disbursement quota, which is to provide a tool to ensure that charitable funds are spent on charitable activities, a disbursement quota is not necessarily a “bad thing.” It can be, and arguably was at one time, an easy test for the bulk of the charities registered under the *Income Tax Act*. A board of directors, senior management, a potential donor, Canada Revenue Agency, the Public Guardian and Trustee in Ontario, and the courts could all look to a relatively simple formula to see if the charity was spending its money on charitable activities.

The 80% rule alone was simple and straightforward: A charitable organization received \$100,000 in donations for which it issued receipts in Year 1 and was required to spend at least \$80,000 directly on charitable activities in Year 2. Similarly, a public foundation (in a very simplified calculation) had assets of \$1,000,000 and was required to spend at least \$35,000 on its charitable purposes, usually to provide grants to charitable organizations. The simple approach provided relatively clear safe harbours for charities, and their boards and management. If the charity found itself in the safe harbour, the risk of problems arising from an audit was much reduced. The charity was in compliance and met a critical benchmark to demonstrate that it was using its resources on its charitable activities.

The rules became complicated to adjust to reality and to prevent abuse. What about the non-receipted income? What about transfers from one charity to another charity? What about a charity that legitimately wants to create a fund to construct a new building in 5 years? What about donors who want to create a sustainable organization through a “10 year gift,” or with an endowment fund? What about a charity that has accumulated a large asset base, much of which is not being used for its charitable purposes? What about charities that do not carry out charitable activities? While the sector at times prefers not to focus on internal problems, they do exist.⁴ The end result has been an overly complex disbursement quota formula⁵ – one that no longer “worked.”

Budget 2010:

The Federal Government seems to have recognized this fundamental problem in its *Budget 2010*. The Highlights section summarized the purpose of the changes as follows:

The Government is proposing significant reforms to the disbursement quota to reduce administrative complexity and better enable charities to focus their time and resources on charitable activities.

The disbursement quota, introduced in 1976, was intended to ensure that a significant portion of a registered charity's resources is devoted to its charitable purposes. Many observers have noted that the disbursement quota has been unable to achieve its intended purpose, as it does not take account of the varying circumstances of individual charities. Stakeholders such as Imagine Canada have also noted that the disbursement quota imposes "an unduly complex and costly administrative burden on charities – particularly small and rural charities."

In recent years, the Canada Revenue Agency's ability to ensure the appropriateness of a charity's fundraising and other practices has been strengthened through the introduction of new legislative and administrative compliance measures and the provision of additional resources. These actions provide a more effective and direct means to fulfill many of the objectives of the disbursement quota.

Budget 2010 proposes to eliminate all disbursement quota requirements except those related to the requirement to annually disburse a minimum amount of investments and other assets not used directly in a charity's operations. This requirement is being updated to provide charitable organizations a greater ability to maintain reserves to deal with contingencies.

The reformed disbursement quota rules will apply to charities for fiscal years ending on or after March 4, 2010. These changes will have no fiscal impact.⁶

A Budget is a political document and as such always includes messaging (Bourgeois, 1999). One of the clear messages in the Highlights section is that the Minister of Finance continues to be concerned that charitable funds are used for charitable purposes – which is why the federal and provincial treasuries have given up the tax revenues. A second message is that the Minister is satisfied that the Canada Revenue Agency has the tools necessary to ensure compliance.

A third message is an interesting one, perhaps in what is both said and unsaid. The Minister was not willing to "spend" any more on charities in this measure. These changes may have a positive impact on charities, but there will be no "fiscal impact" on the federal consolidated revenue fund. What is not said throughout the budget papers is that charities are important. The word "charity" is not in the Budget paper's Quick Index.⁷

This approach continues in the Supplementary Information on the Tax Measures in the Budget papers. This part of the Budget papers, while also part of the overall political message, delves into more of the legal and bureaucratic background. At page 349,

The Budget paper notes:

It is estimated that Canadian individuals will receive \$2.4 billion in federal tax relief on charitable donations of \$8.8 billion in 2009. In addition, corporations benefit from a deduction with respect to charitable donations.

Charitable activities are not defined in the Income Tax Act; instead, the meaning of charitable purposes and charitable activities in Canada is largely determined by jurisprudence. Charities must devote their resources to charitable purposes. The Income Tax Act specifies requirements for registration as a charity as well as grounds for revocation for that status. The Canada Revenue Agency determines the eligibility of an organization to be a registered charity for federal income tax purposes, based on an examination of the organization's purposes and activities. In addition, charities are subject to corporate and trust law.

A comment at page 350 adds an interesting wrinkle – the Budget paper notes 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. For example, some charities have a wide range of revenue sources from which to fund their charitable activities, such as grants received from governments and revenues from related business activities. Since all charitable expenditures count toward meeting the disbursement quota, these charities have little difficulty satisfying it even if they do not spend their tax-receipted donations on charitable activities.

Arguable, there are two messages in this paragraph. First, the Minister articulates a view that the “disbursement quota” is an “expenditure rule.” Second, this “expenditure rule” may not have worked as intended. The Budget Plan continues that “recent legislative and administrative initiatives had strengthened the Canada Revenue Agency’s ability to ensure that a charity’s fundraising and other practices are appropriate.” This sentence may be the most important one in the Budget Plan – the Minister is satisfied that other measures will be used to ensure appropriateness, not only with respect to fundraising but also “other practices.”

Interestingly, what these “other practices” are is not articulated. The Budget paper identifies the CRA Guidance CPS-028 (Fundraising by Registered Charities) as being one of the initiatives in place to guide charities on acceptable fundraising practices. The Budget paper continues, at page 351:

The Canada Revenue Agency may impose sanctions or revoke the registration of a charity in situations where charities their funds inappropriately, such as in cases where there is undue private benefit. These tools provide a more effective and direct means to fulfill the objectives of the charitable expenditure rule of the disbursement quota.

Budget 2010 proposes to reform the disbursement quota for fiscal years that end on or after March 4, 2010. Specifically, *Budget 2010* proposes to:

- repeal the charitable expenditure rule;
- modify the capital accumulation rule; and
- strengthen related anti-avoidance rules for charities.

The Government will monitor the effectiveness of the Canada Revenue Agency's guidance on "Fundraising by Registered Charities," and take action if needed to ensure its stated objectives are achieved.

CONCLUSION

The Budget announcement will likely prove a positive one. It reduced complexity in the calculation of the "disbursement quota." On the other hand, it also largely eliminated the safe harbour for most charities. That safe harbour has been replaced by more general and at times not well articulated principles. For example, what is meant by "other practices?" What will be the criteria to assess if a charity has used "funds inappropriately?" Undue private benefit would likely have been caught using the rules in place prior to March 2010. What other uses of funds will be considered inappropriate? Who will be the decision-maker? What criteria will be used? Given the reference to grants from governments on page 350, will the Canada Revenue Agency or the Government exercise other tools to address this source of revenue? Or revenues from other sources, such as "related business"?

Is *Budget 2010* gold for charities? Or fool's gold?

NOTES

1. Budget 2010 (2010, March 4). Leading the Way on Jobs and Growth. For details see www.budget.gc.ca/2010/plan.
2. Contributors to *The Philanthropist* have long discussed and, in some cases, recommended reform to the disbursement quota and greater sensitivity to the realities that face charities – both charitable organizations and charitable foundations. See for example, Burrows, Malcolm D., 2010; Canadian Bar Association, 2004; Canadian Bar Association, 2002, "Position Statement," regarding 4.5% disbursement quota on assets of foundations; Gibson, Robert H., 1985; Hoffstein, Maria Elena & Teresa L.M. Man, 2007.
3. Royal Commission on Taxation (1966). Report of the Royal Commission on Taxation. Ottawa: Queen's Printer.
4. This view may, of course, result from the author's experience as a regulator in a public agency that regulates, to a limited extent, charitable organizations.
5. Karen J. Cooper and Terrance S. Carter note in their analysis of the Budget 2010 announcement, that "The DQ rules are too complex to detail here." See Cooper, Karen J. & Terrance Carter (2010, March 8). Significant Benefit for Charities in 2010 Federal Budget DQ Reform. *Charity Law Bulletin* 197, URL: <http://www.carters.ca/pub/bulletin/charity/2010/chylb197.htm>.

6. <http://www.budget.gc.ca/2010/plan/chap3d-eng.html>. See also Chapter 3.4 of the *Budget Plan*, "Supporting Families and Communities and Standing Up for Those Who Helped Build Canada," 128–129. The chapter title is an interesting one in which to locate changes to the disbursement quota. The complete Budget Plan is at <http://www.budget.gc.ca/2010/plan/toc-tdm-eng.html>.

7. Budget 2010 (2010, March 4). Leading the Way on Jobs and Growth: <http://www.budget.gc.ca/2010/plan/topics-sujets-eng.html#C>.

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