December 4, 2002

Mr. Len Farber
General Director, Legislation
Tax Policy Branch
140 O'Connor Street
Ottawa ON K1A 0G5

Dear Mr. Farber:

Re: Income Tax Issues for Charities

I am writing as the Chair of the National Charities and Not-for-Profit Law Section to thank you for, and to follow up on, our meeting in January. We discussed several areas which we believe need either legislative change through the Department of Finance or administrative change or clarification by the Canada Customs and Revenue Agency. We appreciate the opportunity to give you our views and hope to be able to meet with you regularly to discuss matters of mutual interest.

The purpose of this letter is to summarize our discussions and to provide additional input in some of the areas we discussed. The headings are consistent with the written submissions we reviewed at our meeting.

4.5% Disbursement Quota

In our submissions, we said that many charities have difficulty meeting the 4.5% disbursement quota in the current investment climate offering low nominal returns. We suggested that one possible solution would be to replace "0.045" in the definition of disbursement quota with "prescribed amount." We suggested that the prescribed amount should be set annually in advance as a portion (perhaps one-half) of the yield on Government of Canada bonds.

You confirmed that the Department is sympathetic but might be reluctant to set the capital disbursement quota as low as one-half of the government bond rate.

Since the purpose of the existing 4.5% disbursement quota is to prevent charities from accumulating their income without devoting an appropriate amount to charitable activities or grants, we believe that this purpose could be better met in other ways. For example, the prescribed rate could be set at the lesser of 80% of the charity's actual returns on the relevant portfolio and 7%. This would protect charities in the event of low rates (as is currently the case), while also providing for the possibility of higher required payouts when a charity achieves higher returns. The 7% is designed to provide a charity which engages in higher risk/return investment with a cushion from year to year.

During the discussion of the 4.5% disbursement quota, Wolfe Goodman gave you a memo which described a technical anomaly in the formula for the 4.5% test. You agreed that this technical anomaly was not intended and a technical amendment would be made to address it.

Capital Gains and Ten-Year Gifts

The problems with the 4.5% disbursement quota are particularly serious for charities with endowments composed of unexpired ten-year gifts. CCRA takes the position that it is not possible to use realized capital gains from property subject to a ten-year gift to supplement other income from that property in order to meet the 4.5% disbursement quota. As a result, charities are faced with an impossible situation. This is especially so for the many charities that invest on a total return basis, which does not distinguish between capital gains and income. If a total return investment approach is used for an endowment subject to a ten-year gift, and this results in a large capital gain but no income, it is not possible to meet the 4.5% disbursement quota.

While you confirmed that the Department was drafting legislation to deal with this issue, we understand it has not been released yet and would again like to draw your attention to our previous proposal:

> One possible solution would be to amend the definition of ten-year gift by stipulating that during the ten-year period the foundation may disburse annually up to the greater of 4.5% (or the prescribed amount – as proposed above) and the actual income from the ten-year gift during the year. This would allow the foundation to use capital gains (or even original capital) to meet its disbursement quota if necessary. Of course, donors would still be free to impose more stringent conditions if they wished and conditions on past gifts would continue to apply as a matter of provincial law.

Transfers of Property Subject to Ten-Year Conditions

We discussed an issue which arises when property subject to a ten-year gift is transferred from one charity to another. Until recently, it was assumed that a registered charity transferring property subject to ten-year conditions could transfer it as a specified gift with no adverse disbursement quota consequences for the transferor or transferee charity.

However, this issue was referred recently to the CCRA Rulings Directorate, which took the position that the terms of paragraph A.1 of the definition of disbursement quota in subsection 149.1(1) had an unfortunate (and unintended) result. Because the proposed transfer in that situation included ten-year gifts being expended in the year by being transferred to another foundation, 80% of the amount of the gifts was required to be included in the transferor's disbursement quota in the year of transfer. However, subsection 149.1(1.1) prohibited the specified gift from being deemed to be an amount expended in the year on the transferor's charitable activities. This prevented the transfer because the transferor would not have been able to meet its disbursement quota if the transfer took place.

If the view of the Rulings Directorate is correct, it implies that a drafting error was made in 1993 when paragraph A.1 of the definition of disbursement quota was added. Subparagraph (a) of this paragraph should read "is expended in the year, otherwise than by way of specified gift." Although Brian Ernewein took the position that there may be circumstances in which charities should not be able to transfer ten-year gifts to another charity, we find it difficult to accept this position. Funds held by a charity subject to a ten-year condition are essentially funds held by the charity subject to a trust. The general trust law rule on substituting trustees is that unless a trust instrument explicitly prohibits a change in the identify of a trustee, the change is permitted. We can see no reason why income tax law should frustrate this sensible common law rule. Thus, we ask that the Department make this technical amendment to correct the 1993 drafting error.

Grants by Registered Charities to Foreign Charities

At our meeting, we discussed the differences in the applicable provisions of the *Income Tax Act* between the ability of a public or private foundation on one hand and the ability of a charitable organization on the other hand to make grants to organizations which are charitable at law but which are not qualified donees (generally, foreign charities). We also discussed the refusal of the CCRA Charities Directorate to interpret the *Act* in this way despite what we believe is the clear wording in the *Act* on this matter.

While a registered charity which would otherwise make grants to a foreign charity may instead engage that foreign charity as its agent to carry out particular charitable activities, agency arrangements are cumbersome and the reporting requirements under them are, at least as set out in the CCRA Guide (RC4106: *Registered Charities Operating Outside of Canada*), not practical for small Canadian registered charities or even for large Canadian registered charities which propose to fund small charitable projects outside Canada. In addition, the recent decisions in *The Canadian Committee for the Tel Aviv Foundation* and *Canadian Magen David Adom for Israel* illustrate the potential problems for a charity.

We discussed the possibility of a *de minimus* exception to the requirement for agency agreements. Our position is that Canadian registered charities, whether they are registered as public foundations, private foundations or charitable organizations, should be able to make small grants to foreign charities. One way to regulate this would be to exclude such grants in calculating the disbursement quota of the charity (as is presently the case with private foundations and public foundations) and also to provide that no Canadian registered charity could use this *de minimus* rule to make more than $5,000 of grants to any particular foreign registered charity in any particular year. While a Canadian registered charity making such a grant should still be required to show at audit that the grant is made for a charitable purpose, there should be no need for the type of accounting records required by CCRA in the context of agency agreements or joint venture arrangements. We expect that the charitable nature of the *de minimus* grant could be shown if the granting charity imposed trust conditions on the grants requiring them to be spent for particular charitable purposes.

Gifts Made by Will and the Deeming Rule in Subsection 118.1(5)

Our previous submission suggested that the rule in subsection 118.1(5), which provides that gifts made by an individual in a will are deemed to have been made immediately before the individual's death, be supplemented with a carry-forward provision. You asked for our further thoughts on this issue.

There are many situations in which an individual makes a large gift by will but does not have sufficient taxable income in the year of death to use the charitable donation tax credit which results. We can see no tax policy reason why the donation tax credit should not be available for carry forward from the terminal year into the first taxation year (or even subsequent taxation years) of the estate if that tax credit cannot be fully used in the terminal tax return of the deceased. Since there are good policy reasons for permitting an individual to carry forward unused tax credits for charitable donations, the same policy reasons should permit a carry forward from the terminal return into the estate returns. Indeed, since individuals do not generally time their date of death for tax reasons, we think a carry forward into the estate is even less open to manipulation by taxpayers than is the current carry forward for individuals.

Gifts of Public Securities

In our previous submission, we discussed the much appreciated relief for gifts of listed public company shares and mutual fund units to charitable organizations and public foundations through a reduced inclusion for capital gains. We suggested that this be expanded to include similar gifts to private

foundations, and if there were particular abuses which concern CCRA or the Department, they should be dealt with directly by specific exceptions.

At our meeting, your officials suggested that a donor should not be able to receive enhanced upfront tax recognition for a gift of a control block of public company shares to a private foundation where the individual would still be able to control that particular block. If this is the basis for your concern, we believe that it could be met by extending the reduced capital gains inclusion rate on a donation of public company securities to private foundations, subject to an exception for a gift which itself constitutes a control block in the company or a gift that together with other shares held by the donor and persons who do not deal with the donor at arm's length, constitutes a control block, where that control block would not exist without including the shares donated to the private foundation. In those circumstances, the reduced capital gains inclusion rate would apply only if the shares were sold into the public market by the private foundation within a stipulated period and those shares or substituted shares were not reacquired by the foundation or by any person who does not deal at arm's length with the donor within 30 days. We believe that this should address the "control" concern.

Other Issues

At our meeting, we discussed other issues covered in our original submissions. Some of these relate more to the CCRA Charities Directorate and have been addressed in the report of the joint regulatory table of the voluntary sector initiative. There were other issues on which we were not asked for further submissions. Nevertheless, we thank you for the opportunity to provide you with our views.

If you agree it would be helpful, members of the Section are prepared to meet with Department officials or CCRA officials to discuss the issues dealt with in this letter or our previous submissions, or to assist in drafting technical amendments.

We hope it will be possible to continue an ongoing dialogue with the Department and CCRA. We believe this can give you and CCRA a better understanding of the concerns which we face as practitioners in dealing with the tax law and tax administration as they apply to charities. At the same time, we have found this process useful in understanding the policy reasons behind legislative and administrative developments in this area.

We look forward to your comments.

Yours very truly,

Terrance S. Carter
Chair
National Charities and Not-for-Profit Law Section

JMP:jb

cc: Lee Workman
Maureen Kidd