July 20, 2009

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Dear Ms. Levonian and Mr. McCauley:

Re: Concept Paper on Reform of the Disbursement Quota Regime

The National Charities and Not-For-Profit Law Section of the Canadian Bar Association (CBA Section) has for many years raised concerns on the provisions of the *Income Tax Act* relating to the disbursement quota and the difficulties it has posed for charities and not-for-profit organizations. These concerns range from the complexity of the provisions to the challenges encountered by small and rural charities that operate primarily with donor funds. In addition, the provisions are of less relevance to large charities that are primarily government funded.

The attached concept paper was undertaken with a view to provide constructive suggestions for reviewing s. 149.1 of the Act. The CBA Section has identified the government's policy objectives and suggests different mechanisms for their pursuit.

The concept paper is intended to motivate discussions for alternatives to the existing regime. We look forward to your feedback and hope to have the opportunity to meet with you to provide further input on the suggested changes.

Yours truly,

(Original signed by Susan May Manwaring)

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THE CANADIAN
BAR ASSOCIATION
L'ASSOCIATION DU
BARREAU CANADIEN

Concept Paper on Reform of the Disbursement Quota Regime

NATIONAL CHARITIES AND NOT-FOR-PROFIT LAW SECTION
CANADIAN BAR ASSOCIATION

July 2009

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PREFACE

The Canadian Bar Association is a national association representing 37,000 jurists, including lawyers, notaries, law teachers and students across Canada. The Association's primary objectives include improvement in the law and in the administration of justice.

This submission was prepared by the National Charities and Not-For-Profit Law Section of the Canadian Bar Association, with assistance from the Legislation and Law Reform Directorate at the National Office. The submission has been reviewed by the Legislation and Law Reform Committee and approved as a public statement of the National Charities and Not-For-Profit Law Section of the Canadian Bar Association.

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TABLE OF CONTENTS

Concept Paper on Reform of the Disbursement Quota Regime

I. INTRODUCTION 1

II. THE DISBURSEMENT QUOTA 1

III. PROPOSALS 6

IV. EVALUATION OF THE PROPOSALS 8

V. CONCLUSION 8

Concept Paper on Reform of the Disbursement Quota Regime

I. INTRODUCTION

This concept paper was developed by a working group (Working Group) of the Charities and Not-for-Profit Law Section of the Canadian Bar Association (CBA Section). It has been prepared for discussion purposes only and is intended to initiate reflection and further study.The ideas and arguments presented do not represent recommendations or positions endorsed by the CBA Section.

The paper is motivated by the belief of members of the bar and the voluntary sector that substantial reform of the current disbursement quota (DQ) regime is required. It describes why reform is desirable and proposes two potential replacements for the existing system.

In summary, the paper suggests that the DQ regime results in distortions in the gifting decisions of donors to charities and in the expenditure and investment decision-making of charities. It suggests that these distortions are substantial and are probably not justified by any rational regulatory objective. Proper regulatory objectives are identified and two options to implement them are described, at a conceptual level. The Working Group believes that the two options may be more efficacious from a regulatory point of view and less intrusive and harmful from the point of view of charities. Both options assume that charities will be subject to an improved transparency regime through better reporting and dissemination of reporting.

II. THE DISBURSEMENT QUOTA

A requirement to disburse a portion of assets within a specified period of time was first imposed on registered charities in the mid-1970s. Very little is written on the history of the DQ but one useful source of information is chapter 10 of the Ontario Law Reform

Commission *Report on the Law of Charity*. Some contemporaneous studies are discussed in the OLRC Report. It appears, based on this history, that:

- the DQ regime was initially intended to do two things, namely, to regulate fundraising costs (current component) and to regulate the capacity of some charities to accumulate donations, capital and income (capital component);
- the DQ regime was initially founded on the empirical claim that charities are either fundamentally active or fundamentally passive, or at least that it was sensible to regard them in this way for the purposes of regulation; and,
- the DQ regime is still founded on the empirical claim that charities are either closely held (private foundations) or widely held (charitable organizations and public foundations), or at least that it was sensible to regard them in this way for the purposes of regulation.

The DQ is calculated using the following formula: A+A.1+B=B.1. The components of this formula are defined as follows:

- Component A: 80% of the previous year's receipted donations not including donations of property that is enduring property.
- Component A is the current component of the DQ.
- Component A.1: 80% of amounts disbursed by the charity from its enduring property on its own charitable activities and 100% of amounts disbursed by the charity from its enduring property in the form of gifts to qualified donees, less, in both cases, any amount disbursed from its realized capital gains (accounted for in its "capital gains pool") in order to satisfy component B.1 of the DQ.
- Component A.1 brings into the DQ amounts previously excluded from component A because they were received as enduring property and, as such, were accumulated by the charity permissibly. The obligation to disburse generated under component A.1 is discharged by the disbursement described in component A.1 itself. For that reason, component A.1 might be regarded as an anti-avoidance rule. The function of the capital gains pool exception is to permit a charity to disburse some enduring property – realized capital gains – to meet component B.1 of the DQ. This element of component A.1 is therefore relieving in nature.
- Component B: 100%, in the case of private foundations, and 80%, in the case of other charities, of gifts received from other charities, other than specified gifts and gifts of enduring property.
- Component B is an anti-avoidance rule. It prevents charities from colluding to avoid the DQ by engaging in charity to charity transfers. The exception for specified gifts is intended to except inter-charity transfers of capital or accumulated income that is "outside" the DQ regime, for example, income accumulated from investments over and above the income from investments disbursed pursuant to component B.1. The

exception for enduring property accommodates inter-charity transfers of enduring property.

- Component B.1: Essentially, 3.5% of a rolling average amount based on the value of its investment property.
- Component B.1 is the capital component of the DQ. It requires the charity to invest its property to earn sufficient income to disburse a certain amount every year.

"Enduring property" is a central concept in the formulation of the DQ regime. The definition of "enduring property" in the *Income Tax Act* is intended to identify the circumstances in which donations to a charity may be accumulated by the charity, as opposed to expended currently under component A. The underlying regulatory notion is that donations not required to be disbursed currently under component A, i.e., gifts of enduring property, will be subject to the 3.5% quota requirement under component B.1, the capital component.

The concept "enduring property" is currently defined to include property received by bequest, as proceeds of life insurance, via RRSP and RRIF designations, by gifts or trusts subject to a condition that the property or substituted property be held for at least ten years, and by gifts from a charity to a charitable organization subject to a condition that they be held for not more than five years and used for certain projects or acquisitions.

All the elements of this definition except the last depend entirely on the intentions of private donors. This reflects and accommodates the reality of endowments in the charity sector. The last is a rough response to the artificial distinction between two donation flows and two corresponding DQ components undermining intelligent capital and project spending in the sector because it recognizes only two expenditure periods for capital, one year and more than ten years.

There are a number of difficult concepts used in the DQ regime whose definition or application under the Act is not always clear. We do not review these conceptual or practical difficulties in detail except to note that they exist and present a challenge to explain and apply. The Canada Revenue Agency (CRA) has responded to these technical challenges by taking on the calculation of the DQ for registered charities as part of the annual filing process. The complexity and rigidity of the DQ regime also leads to compliance challenges,

especially for charities that rely heavily on receipted donations and for small charities that may not enjoy the economies of scale in conducting non-program activities available to larger charities.

It is useful, however, to summarize some of the main problems of the DQ regime from a policy point of view:

- The division of donation flows into current and capital components requires an artificial concept ("enduring property") that restricts the types of conditions as to the timing of expenditures of capital that donors can place on gifts /or that charities can encourage or agree to. The question is: why as a matter of tax policy does the legislator want to channel donor intentions in this restrictive way?
- The corresponding division of the DQ regime into current and capital components ignores disbursement plans that are different from the one year, five year and ten year disbursement plans accommodated under the concept "enduring property". The question is: why as a matter of tax policy does the legislator want to channel the capital expenditures of charities in this way?
- The inclusion of substituted property or capital growth in the definition of "enduring property" (ten-year gifts only) undermines the possibility of total return investing by charities since it requires that the private law conditions of capital donations prohibit the expenditure of capital growth. There is now an accommodating exception in the form of the capital gains pool, but it is of limited utility. The question is: why as a matter of tax policy does the legislator want to regulate the investment strategies of charities?
- The current component of the DQ regime imposes an arbitrary expenditure requirement. The expenditure requirement is arbitrary because it uses an arbitrary fraction (80%) and an arbitrary distinction ("charitable" as compared to "administrative" expenditures). This creates distortions in the expenditure decisions of charities.
- The capital component of the DQ regime imposes an arbitrary expenditure requirement. The expenditure requirement is arbitrary because it uses an arbitrary fraction (3.5%) against an arbitrary base (previous two years' rolling average). This creates challenges in declining investment markets.

At a highly abstract level, the state has two broad policy objectives in regulating charity: the protection and facilitation of entities (charities) pursuing the common good and of donor autonomy to gift to charities to support them in these endeavours; and the promotion of efficient, effective and timely use of tax expenditures to produce public goods.

The DQ regime aims at the second broad policy objective only. A fair and reasonable interpretation of the DQ provisions in the Act is that it aims to implement four specific regulatory objectives:

- **Current gifts disbursement**: Registered charities receiving current donations should disburse those donations on a current basis.
- **Anti-accumulation**: Registered charities should not accumulate income or to defer expenditure of capital or capital growth indefinitely.
- **Efficiency**: Registered charities should limit administrative expenses and maximize the amount of resources available for charitable work.
- **Fundraising efficiency**: Registered charities should limit fundraising expenses and maximize the amount of resources available for charitable work.

The current DQ requirements are not an effective means to achieve the third or fourth objectives.

The fourth objective is a subset of the third objective. However, since fundraising is a peculiar activity of the sector and fundraising abuses are relatively prevalent, it is useful to regard it as a separate regulatory objective. Arguably, the fourth objective is more adequately and appropriately dealt with in fundraising guidelines, which are now available.

The third objective can be pursued more effectively using donation "markets". The DQ regime is a blunt regulatory instrument not conducive, on its face, to efficient use by charities of their resources. The donation market could be enhanced if charitable operations were more transparent. This could be achieved through appropriate reporting requirements and public dissemination of filed reports. Both options outlined in the next section assume the implementation of improved reporting and dissemination of reporting to enhance transparency and therefore the efficient and effective operation of donation "markets".

Only the first and second regulatory objectives are intelligently pursued through a DQ regime. The first and second regulatory objectives might be simplified by articulating them as one objective – the prevention of undue accumulation of donations, income and capital. But it may be useful for some purposes to articulate these objectives as two, so we leave them that way.

The reforms proposed in the next section seem to the Working Group to be more practical ways of pursuing the first two regulatory objectives, while minimizing the impact of the DQ regime on the design of gifts and on the design of expenditure programs and investment programs of charities. The descriptions present two possible models of reform at the conceptual level only.

III. PROPOSALS

Reform of the DQ should aim to achieve, as much as possible, the following goals:

- Pursue only the first and the second objective;
- Respect the autonomy of donors in placing conditions on gifts;
- Accommodate diversity in the timing of expenditures by charities;
- Accommodate diversity in investment strategies of charities; and
- Aim at regulatory simplicity, especially in compliance.

The need for reform is that the current DQ regime does not achieve either of the first two objectives very effectively and causes distortions in the gifting decisions of donors and in the expenditure and investment decisions of charities.

Two are options proposed. The first option is a simplification of the current approach. The second option targets “undue accumulations” directly by identifying “undue accumulations” using readily available accounting concepts and requiring that they be disbursed or be subject, ultimately, to a penalty tax. Both options assume that the efficiency objective is pursued through enhanced transparency.

Option 1:

- Repeal component A of the DQ in the expectation that undue accumulation of current gifts will be adequately dealt with in a modified version of component B.1. Therefore, concepts whose functions are to sort donations into current and capital would be repealed.
- Simplify component B.1. Under a modified component B.1, a charity would simply be required to disburse a percentage of its “investment assets” annually. The percentage amount would be stipulated in regulations to the Act.

Option 2:

- Repeal the DQ and replace it with a regime that directly identifies "undue accumulations" and sanctions them, ultimately, with a penalty tax. Elements of this new scheme are listed below.
- Registered charities would calculate their income in accordance with Generally Accepted Accounting Principles (GAAP). The charity's "Statement of Operations" or income statement would list all revenues (government grants, donations, foundation grants, investment income (all "contributions") and expenses (service delivery, salaries, interest and amortization) in the calculation of GAAP income.
- Registered charities would adjust their GAAP income in accordance with further adjustments specified in the *Income Tax Act*, including:
  - Provisions permitting deferral accounting in some circumstances (e.g., when a registered charity fundraises for a multi-year capital project);
  - Appropriate treatment of deductibility of interest expense and depreciation, whether incurred as part of charitable work or associated with assets not currently used for charitable work;
  - Provisions dealing with the recognition of gifts-in-kind in the calculation of income (though subject to adjustment if within an excluded or deducted revenue category as set out below); and
  - Provisions permitting registered charities to deduct or exclude certain revenue items from income, as follows:
    - Contributions excluded or deducted in accordance with any terms or conditions imposed (e.g., endowments, trusts or designated donations);
    - Contributions excluded because of their source (e.g., testamentary gifts, government grants, earned income, sale of surplus assets, and perhaps gaming proceeds);
    - Contributions or other income whose use is restricted by the charity itself for acceptable reasons. The *Income Tax Act* might identify permissible levels for reserves, including operational reserves, reserves for capital projects and self-insurance. Categories of assets devoted to long term charitable work could also be specified.
  - As a result of the above calculations, surplus income would be identified and treated as an "undue accumulation". The Act would require that the undue accumulation income must be expended on charitable work within a specified period of time or transferred to another charity or qualified donee or, ultimately, subject to a penalty tax.
  - The new scheme may be applied differently or not at all to types of charities, such as small or charitable organizations, depending on carve-outs based on the need for simplicity.

IV. EVALUATION OF THE PROPOSALS

Option 1 is relatively straight forward to implement. The compliance costs under Option 1 appear quite low. Charities would have to keep track of their "investment assets" in accord with the rules to implement Option 1.

Since many charities own property already subject to five- and ten-year conditions some grandfathering would be required to accommodate these. Going forward, charities and donors would negotiate gift terms relatively freely. Charities would only have to ensure that the gift conditions did not impare their ability to meet the new DQ.

Exemptions might be available depending on the size of a charity's investment assets.

Option 2 is complicated to implement. Although a charity's accounts will be based on GAAP, specific rules will be required to determine the appropriate level of adjustment to identify undue accumulations. With its sophisticated rationality comes legislative and possibly compliance complexity. However, the design of Option 2 could scale back the complexity. The value of Option 2 is that it addresses the regulatory objective directly and coherently.

The attached Appendix, prepared by PvC for discussion purposes only, provides a detailed analysis of the potential treatment of a number of categories of income under this scheme.

V. CONCLUSION

The CBA Section welcomes further discussion of this issue, and would be pleased to provide further information on the material outlined above or explore other ways to replace or revise the disbursement quota.

Appendix

CBA - DQ Project

PREPARED BY PwC FOR DISCUSSION PURPOSES ONLY

ANALYSIS OF ACCOUNTING TREATMENT UNDER GAAP FOR CONTRIBUTION AND INCOME SOURCES

	Contribution or Income Source Scenario	Accounting Treatment	Proposed Accounting to Tax Adjustment for T3010 Purposes
A.	Gift of cash - unrestricted	- Under **restricted fund method,** on receipt of cash gift, immediate recognition as donation revenue in the statement of revenues and expenditures in the general fund	- no adjustment required
		- Under **deferral method,** on receipt of cash gift, immediate recognition as donation revenue in the statement of revenues and expenditures in the general fund	- no adjustment required
B.	Restricted gift with conditions by donor to hold the capital of the gift for a period of time greater than one year	- Under **restricted fund method,** on receipt of restricted gift, immediate recognition as donation revenue in the statement of revenues and expenditures in the endowment fund	- adjust accounting income to allow for an endowment reserve
		- Under **deferral method**, on receipt of restricted gift, if gift is for expenses of a future period, defer recognition of donation revenue as deferred revenue in the balance sheet and recognize the revenue in the statement of revenues and expenditures in a subsequent year when the expense is recognized	- adjust accounting income to recognize donation revenue and if the gift is to be used in an identifiable future period in the operations of the charity, adjust accounting income to allow for an operating reserve
		- Under **deferral method**, on receipt of restricted gift, if gift is for the purchase of a capital asset, defer recognition of donation revenue as deferred revenue in the balance sheet and in subsequent years, recognize the revenue in the statement of revenues and expenditures equal to the amount of amortization expense. If the capital asset is not being amortized, recognize the gift as a direct increase to net assets (i.e., direct adjustment to net equity)	- adjust accounting income to recognize donation revenue and adjust accounting income to allow for a capital reserve

	Contribution or Income Source Scenario	Accounting Treatment	Proposed Accounting to Tax Adjustment for T3010 Purposes
		- Under **deferral method**, on receipt of restricted gift, if an endowment gift, recognize the gift as a direct increase to net assets (i.e., direct adjustment to net equity)	- adjust accounting income to recognize donation revenue and adjust accounting income to allow for an endowment reserve
C.	Restricted gift with condition by donor to designate the gift for a specific purpose	- Under **deferral method**, on receipt of restricted gift, if gift is for expenses of current period, immediate recognition as donation revenue in the statement of revenues and expenditures	- no adjustment required unless the donor stipulates that a condition of the gift is that it must be used for capital in which case the accounting income would be adjusted to allow for a capital use reserve
		- Under **restricted fund method,** on receipt of restricted gift, immediate recognition as donation revenue in the statement of revenues and expenditures in an appropriate restricted fund if there is one or in the general fund if there is not an appropriate restricted fund	- no adjustment required unless the donor stipulates that a condition of the gift is that it must be used for capital in which case the accounting income would be adjusted to allow for a capital use reserve
D.	Gift of real estate - **used in charitable or administrative activities** of the charity	- Under **restricted fund method,** on receipt of gift in kind, recognition of real estate as a capital asset on the balance sheet and recognition as donation revenue in the statement of revenues and expenditures	- adjust accounting income to allow for a capital use reserve
		- Under **deferral method,** on receipt of gift in kind, recognition of real estate as a capital asset on the balance sheet and defer recognition of donation revenue as deferred revenue in the balance sheet and in subsequent years, recognize the revenue in the statement of revenues and expenditures equal to the amount of amortization expense. If the capital asset is not being amortized, recognize the gift as a direct increase to net assets (i.e., direct adjustment to net equity)	- adjust accounting income to recognize donation revenue and adjust accounting income to allow for a capital reserve
E.	Gift of real estate - **not used in charitable or administrative activities** of the charity	- Under **restricted fund method,** on receipt of gift in kind, recognition of real estate as an investment asset on the balance sheet and recognition as donation revenue in the statement of revenues and expenditures	- no adjustment required

	Contribution or Income Source Scenario	Accounting Treatment	Proposed Accounting to Tax Adjustment for T3010 Purposes
		- Under deferral method, on receipt of gift in kind, recognition of real estate as an investment asset on the balance sheet and recognition of gift as a direct increase to net assets (i.e., direct adjustment to net equity)	- adjust accounting income to recognize donation revenue
F.	Gift of insurance policy	- on transfer of policy to charity, recognition of cash surrender value as donation income in the statement of revenues and expenditures. On payment of insurance premiums by the donor of the policy after the transfer of the policy, recognition of the premiums as donation income in the statement of revenues and expenditures.	- no adjustment required
G.	Gift of life insurance proceeds at death	- on receipt of life insurance proceeds, recognition as donation revenue in statement of revenues and expenditures. Represented in the statement of revenues and expenditures as bequest income	- adjust accounting income to allow bequest as an endowment reserve
H.	Gift of registered pension plan (RRSP, RRIF) [charity is named as beneficiary of the plan]	- on receipt of proceeds, recognition as donation revenue in the statement of revenues and expenditures	- adjust accounting income to allow registered plan proceeds as an endowment reserve
I.	Inter vivos gift of property (in-kind gifts)	- if charity's accounting policy* is to recognize gifts in kind: For a non-capital asset gift in kind, recognition of donation revenue in the statement of revenues and expenditures and corresponding expense. - if charity's accounting policy* is to recognize gifts in kind: For a capital asset gift in kind, see D. and E.	- if charity has a gift-in-kind revenue recognition policy, no adjustment is required unless the asset is used in charitable or administrative activities of the charity in which case, adjust accounting income to allow for an operating reserve - see D. and E. '- in future periods, as a capital asset is amortized over its useful life, reduce the capital use reserve (from the prior year's reserve balance) by an amount equal to the amortization expense
J.	Bequests (cash or in-kind gifts)	- if charity's accounting policy* is to recognize gifts-in-kind: For a non-capital asset gift-in-kind, recognition of donation revenue in the statement of revenues and expenditures and corresponding	- if charity has a gift-in-kind revenue recognition policy, no adjustment required unless the asset is used in charitable or administrative activities of the charity in which case, adjust accounting income to allow for an operating reserve or possibly an

	Contribution or Income Source Scenario	Accounting Treatment	Proposed Accounting to Tax Adjustment for T3010 Purposes
		expense.	endowment reserve depending on the terms of the bequest
		- if charity's accounting policy* is to recognize gifts in kind: For a capital asset gift in kind, see D. and E.	- see D. and E. - in future periods, as a capital asset is amortized over its useful life, reduce the capital use reserve (from the prior year's reserve balance) by an amount equal to the amortization expense
		* revenue recognition policy for gifts-in-kind of non-capital asset tangible goods or materials generally exists for charities where the fair market value at the time of gift is ascertainable and where the charity would otherwise use the goods in its operations	
K.	Sale of asset (e.g., real estate) subject to a leaseback where charity (vendor-lessee) retains substantially all of the risks and benefits of ownership	- the lease is capitalized on the balance sheet.	- adjustment may be required depending on if the lease is to be capitalized for tax purposes or if the lease is to be treated as a non-capital lease
L.	Gift of residual interest in an estate or in a trust	- recognition as a bequest gift upon reasonable certainty of receipt of gift (including valuation of residual interest)	- adjust accounting income to allow bequest as an endowment reserve
			- no adjustment required for gift of residual interest in a non-estate trust unless the donor provides that as a condition of the gift, the residual interest is to be preserved for a period greater than one year in which case, see B
M.	Tenant inducement	- inducement amount (i.e., rent-free period or reduced rent per period) is amortized over the life of the lease	- adjust accounting income to recognize the rent expense as paid

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FUND ACCOUNTING METHODOLOGY

Fund Accounting: - a self-balancing set of accounts for each fund established by legal, contractual, and voluntary actions of an organization

- accounting segregation although not necessary a physical segregation of resources

	Restricted Fund Method	**Deferral Method**
Categorization of funds	- general fund - includes unrestricted contributions - externally restricted fund(s) - report contribution in externally restricted fund if there is an appropriate fund otherwise, report contribution in general fund - internally restricted fund(s) - report contribution in internally restricted fund if there is an appropriate fund otherwise, report contribution in general fund - endowment fund	- unrestricted fund - contributions without current or future conditions - restricted fund - report contributions based on use (operating vs. capital) and timing (future vs. present) - endowment fund - contributions are recognized as direct increases to net assets
Contribution recognition	- generally contribution is recognized as income in the statement of revenues and expenditures in the appropriate fund	- contributions for operating purposes are recorded as revenue unless the related expense has been deferred in which case revenue is deferred - contributions for capital purposes are recorded as deferred revenue and subsequently amortized to income as the related asset is amortized