THE CANADIAN BAR ASSOCIATION
L'ASSOCIATION DU BARREAU CANADIEN

September 29, 2021

Via email: charity-bienfaisance@fin.gc.ca

Tax Policy Branch
Department of Finance Canada
90 Elgin Street
Ottawa, Ontario K1A 0G5

Dear Director:

Re: Charities Consultation – Disbursement Quota

The Canadian Bar Association's Charities and Not-for-Profit Law Section (CBA Section) is pleased to comment on issues raised in Finance Canada's consultation on the Disbursement Quota (DQ).[1]

The CBA is a national association representing over 36,000 jurists, including lawyers, notaries, law teachers and students across Canada. We promote the rule of law, access to justice, effective law reform and provide expertise on how the law touches the lives of Canadians every day. The members of the Charities and Not-for-Profit Law Section practice in all areas of charities and not-for-profit law and in every size of practice.

The CBA Section believes that raising the DQ in a low interest environment will be challenging for many charities.

Brief Historical Review

Before discussing amendments to the DQ, a review of its history is helpful to appreciate its complexities. The DQ is the minimum amount a charity must spend on its charitable activities or gifts to qualified donees to ensure charitable funds are used for charitable purposes and not accumulated indefinitely. It is based on a charity's property value that is not used for charitable activities or administration.

The DQ was introduced in 1975 to ensure charities devoted most resources to their charitable purposes. The different types of charities (charitable organizations, public foundations and private foundations) each had their own DQ rules which were hard to understand and implement. A succinct summary of those rules is included in the attached bulletin.[2] In 1984, the rules were significantly simplified. The DQ was reduced to 4.5% for private and public foundations. It was

1 Department of Finance, *Boosting Charitable Spending in our communities*, available online.

2 Carters, Charity & NFP Law Bulletin No. 498 (August 25, 2021), available online.

further reduced to 3.5% in 2004 and extended to charitable organizations. The main impetuses for this reduction were low interest rates and charities' struggle to meet DQ requirements without expending a portion of their capital or long-term gifts. This lower DQ was considered "more representative of historical long-term real rates of return earned on the typical investment portfolio held by a registered charity."[3]

The DQ also required charities to disburse 80% of donation amounts received in the previous fiscal period, other than gifts given, subject to the requirement that capital be held for a minimum of 10 years. This rule added to the complexity of prior DQ rules and was eliminated in 2010.

Current Context

Various concerns about the DQ were raised during the Special Senate Committee on the Charitable Sector's comprehensive review which culminated in the publication of the June 2019 Report, *Catalyst for Change: A Roadmap to a Stronger Charitable Sector.*[4]

Concerns about the DQ raised in various publications can be summarized as follows:

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

Considering whether to increase the DQ percentage is not the only solution to these concerns. More complex factors must be considered.

We understand that some DQ issues flow from concerns that have surfaced in the United States relating to donor advised funds. It is not clear, however, whether these problems exist in Canada given the different tax regimes and regulatory oversight.

Lack of Sufficient and Relevant Data

Before changes are made, it is important to determine if there is a problem, what the problem is and what the fix should be. Available information and data about Canadian charities should be considered to make a reasoned decision on the DQ. The main source of information is the T3010 annual return, which all charities must complete and file with the Canada Revenue Agency (CRA) and which collects information on a charity's DQ and whether it has been met.

Issues go further than whether the DQ has been met. For example, are the investments held by larger charities skewing the average percentage of disbursements? How are charities expending their funds to meet their respective DQs? To understand whether raising the DQ will meet the goal of increasing support for other charities as well as non-profit organizations that collectively provide services to local communities, the CBA Section recommends conducting a proper study to determine what the issues are and the appropriate ways to resolve them.

Concerns about Overcomplicated Compliance

As noted earlier, an onerous compliance burden was imposed on charities for many years due to the DQ regime's difficult-to-understand concepts and rules. It would be regrettable to fix the problem without a better understanding of what the problem is, as it could result in a return to a cumbersome and administratively challenging compliance regime.

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3 *The Budget Plan 2004* "Annex 9 Tax Measures: Supplementary Information and Notice of Ways and Means Motions" (March 23, 2004), available online.

4 Senate of Canada, *Catalyst for Change: A Roadmap to a Stronger Charitable Sector*, available online

The DQ presently applies at the charity level and not at the donor advised fund or individual endowment level. It has been suggested that the DQ apply at the individual fund level and require a minimum disbursement per fund held by a charity. While this leads to greater transparency, it also significantly increases administrative costs for calculation and reporting obligations. Before determining the appropriate "fix", it is necessary to determine if in fact there is a problem. How do charities administer various funds to meet their DQ requirements as a whole? Is there abuse and if so, what is it? The administrative burden cannot be overstated. Many perpetual endowed funds and long-term non-endowed restricted funds are often held by educational and health care charities and requiring them to apply the DQ at the fund level would significantly increase their compliance burdens. Additionally, it is doubtful whether complying with such a complex DQ scheme is possible for charities that hold a significant number of endowments, such as community foundations, universities and colleges, or for smaller charities that may hold smaller funds but have less administrative resources.

Concerns with Raising the DQ

The CBA Section has two concerns with raising the DQ rate:

(1) the low interest environment; and

(2) existing legal obligations with respect to certain funds such as endowment funds.

Low Interest Environment

As noted in our letter to the Minister of Finance in June 2021,[5] raising the DQ in a low interest environment is challenging for many charities. The DQ was reduced from 4.5% to 3.5% in 2004 because it was difficult for charities to meet the higher threshold.

The 2004 Budget Plan stated:

> Budget 2004 proposes to replace the fixed 4.5 per cent disbursement quota rate with a new rate that is more representative of historical long-term real rates of return earned on the typical investment portfolio held by a registered charity.
>
> Given the ongoing nature of charitable activities, it is appropriate to allow charities to maintain a capital asset base on a sustainable long-term basis. Accordingly, the disbursement quota rate on capital assets should be set at a level that can sustain the real value of a charity's capital assets over the long-term. This is consistent with the long-term intentions of donors who provide gifts in the form of endowments.
>
> Analysis indicates that the current 4.5-per-cent disbursement quota rate is high relative to long-term investment returns. Accordingly, the budget proposes to reduce the 4.5-per-cent disbursement quota rate on capital assets to 3.5 per cent. This rate will be reviewed periodically to ensure that it continues to be representative of long-term rates of return.
>
> This change will apply to taxation years that begin after March 22, 2004.[6]

The Bank Rate in March 2004 was 2.25%. The Bank Rate today is 0.5%. The investment rate continues to be a relevant issue for charities with endowments subject to capital payment restrictions and must be considered. Many proponents for change adopt a total return approach, which enables charities to spend from capital appreciation. In other words, for many, raising the

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5 Letter from CBA Charities and Not-for Profit Section to Finance Minister Chrystia Freeland, re Public Consultation on Disbursement Quota applicable to Charities, 15 June 2021, at pp. 1-2.

6 *Ibid*.

DQ back to 4.5% or even higher would require spending capital as well as interest and dividends to meet a higher DQ.

Legal Restrictions

Many funds within charities restrict spending on more than income which, under trust law, is only interest and dividends (not capital gains). Capital, including capital gains, cannot be encroached on and spent in those trust funds because there is a legal prohibition on encroachment of capital which, if violated, would amount to a breach of trust. These funds can be amended without a court order only to the extent permitted by the terms of the trust as set in statute, the charity's incorporating documents, or the instrument creating the fund. Frequently, court applications to vary the terms of these trusts would be required to expend capital, including capital gains. Court applications are costly and uncertain, and the power of the court to vary the terms of a trust are strictly constrained. Even in Ontario, which has a process that permits a charity to obtain a court order to vary a trust without a court application, the process is challenging.

Need for Sustainability and Predictability

Charities use their capital asset base to generate income they can spend or disburse on charitable activities. A higher DQ expenditure should not be implemented without an actuarial analysis to fully understand the need for it, the impact of a higher expenditure requirement and how it may erode charities' capital base.

Charities cannot plan if they do not know whether and to what extent annual funds are available to fund existing and future programs. The value of endowed funds is to give charities sustainable funding and, in the case of foundations, sustainable funding to other charities. Charities must invest charitable funds prudently to allow funds for current activities yet conserve the investment portfolio value against inflation. Increasing the DQ expenditure challenges this balance and encourages riskier investments. Incentivizing riskier investment (which may be problematic under provincial or territorial trust law) to satisfy the DQ requirements that are not otherwise possible to meet puts the long-term capital base at an even greater risk.

Expanding what is a Charitable Disbursement for Purposes of the DQ

Another matter to consider is expanding what is a charitable disbursement for the purposes of meeting the DQ. Investments that involve the dual purpose of achieving the charity's charitable purpose and seeking a financial return do not currently count as a recognized charitable disbursement to meet the DQ. Examples of these types of investments include impact investments, social investments, social finance and program related investments (collectively referred to as program related investments or PRIs).[7]

This lack of recognition is a disincentive for charities with large investment assets from investing these assets in PRIs, which precludes them from using their assets to make a difference for good in achieving their charitable purposes. At a minimum, we suggest that the CRA revise its administrative policy to allow PRIs to be counted toward meeting charities' DQ, at whatever percentage the DQ expenditure is set. This revision can form part of the larger change to how charities devote their resources to charitable activities proposed by Senate Public Bill S-222, *An Act to amend the Income Tax Act* (use of resources).[8]

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7 *See* CRA, CG-014, Community Economic Development Activities and Charitable Registration (July 26, 2012, Revised August 9, 2017), available online.

8 Senate of Canada, *An Act to amend the Income Tax Act (use of resources),* available online.

Responses to Consultation Questions

1. Should the DQ be raised to produce additional funding for charities and to what extent?

The CBA Section does not comment on the policy aspects of this question but highlights the legal issues discussed above, namely the concern that in a low interest environment, raising the DQ requires an encroachment on capital funds. Restrictions on capital expenditures will create legal issues and costly court applications to vary the terms of long-term endowments. Further, forcing charities to expend capital over time to meet the DQ results in a continual need to replenish often-dwindling resources, leading to uncertainty in how charities can sustain long-term programs.

One incentive of the DQ consultation is considering whether there are measures to increase funding for community-based charities. Increasing the DQ percentage is unlikely to achieve this goal. The DQ simply directs charities to spend, it does not direct how to spend funds. Increasing the DQ may appear to be an easy solution. However, it does not consider that foundations support a range of charities with varying needs, with some charities needing additional support and others having a greater need for dependable, sustainable support over time. Nor does it acknowledge that a higher DQ and increasing immediate expenditures and disbursements will have consequences for available funding in future years. We cannot assume that if charities spend more now, their capital base will be replenished or there will be other support avenues in future years. The issues are complex. A nuanced and balanced approach is needed.

2. Would it be desirable to increase the DQ to a level that causes foundations to gradually encroach on investment capital and would it be sustainable in the long-term for the sector?

As noted in our response to question 1, the suggested increase will lead to legal issues and costly court applications as well as an erosion of capital without the certainty of continuing donor support to replenish funds. It will also make investment decisions challenging for the short and long-term needs of the charities and require riskier investments which may be problematic under the local provincial or territorial trust law.

3. What additional tools (monetary penalties, other intermediate sanctions) should be available to the CRA to enforce the DQ rules?

One available tool is deregistration. It is a severe and blunt tool and likely not often used. Many charities comply with their DQ obligations and often exceed them. When DQ rules were more complex, non-compliance was often because of confusion over the rules' meaning. If there are to be intermediate sanctions, taking an "education first" approach should be considered to determine why charities have not been able to meet their DQ obligations and work with them to resolve the issue.

4. Do the relieving and accumulation of property provisions continue to be useful for charities?

Yes. Sometimes charities cannot comply with DQ requirements. The *Income Tax Act* (ITA) has an approval mechanism to accumulate funds, but these rules relate to the right to accumulate for a set period and for a specific purpose. Expanding the rules relating to approval to accumulate should be considered if there are legal impediments preventing a charity from meeting its DQ obligations. Education is also important here so charities can be educated on their obligations and relieving provisions.

5. Do the existing carry-forward provisions strike the appropriate balance between ensuring the timely disbursement of funds and allowing foundations to make large gifts on a more infrequent basis?

Yes, they are appropriate.

6. Are there any temporary changes to the DQ that should be considered in the context of COVID-19 recovery?

We do not think so. Foundations and other charities can spend more than the DQ if funds are needed to support the sector or their current charitable activities, and many do. Charities are constrained more by charitable trust restrictions than the DQ rules. The administration of PRIs described above should be considered to incentivize charities to do more for the communities they serve.

Conclusion

It is not presently possible to conclude whether there is a DQ problem in Canada and, if so, what it is and how to fix it. Data needs to be collected to determine if a DQ rate increase will address the increased financial demands faced by charities.

In addition, it is important to avoid unintended consequences. The key question is to determine how any DQ increase will most effectively help charities manage their resources and serve the public good rather than finding the correct DQ percentage. Determining the DQ percentage constitutes an arbitrary exercise at best and possibly causes damage at worst.

As we have mentioned, these issues are complex and require careful consideration. A nuanced approach is needed rather than choosing a percentage number.

The CBA Section was involved in the last rounds of DQ reform proposals and therefore has a deep sense of its history and evolution. We look forward to working with Finance Canada in the consultation process to ensure that these issues are considered to address concerns in a beneficial way for the charitable sector and the public interests that it serves.

We trust that our input is helpful and welcome the opportunity to discuss it in more detail if necessary.

Yours truly,

(original letter signed by Julie Terrien for Elizabeth Moxham)

Elizabeth Moxham
Chair, CBA Charities and Not-for-Profit Law Section