C.D. HOWE INSTITUTE POLICY CONFERENCE

Strengthening Charity Finance in Canada

Toronto – March 8, 2011

Financing Charities: Thinking Outside the Box

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A. INTRODUCTION

- Charities collectively are already achieving a recognized social good within society
- Although there is room for new initiatives to achieve other social goods, such as new corporate forms to facilitate social enterprise, it is also important to see what can be done to better equip charities in achieving their own charitable purposes
- One of the most common problems, though, faced by charities is that they are generally under funded

- In this regard, there is an obvious failure by the market to provide the financing necessary for charities to be able to provide their own charitable programming
- Therefore, charities need to explore innovative means of financing in order to raise the funds needed for their operations
- This presentation reviews two possible options for increasing financing for charities for consideration:
  - Expanding Program Related Investments
  - Tax Enhanced Charitable Loans

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B. EXPANDING THE PARAMETERS OF PROGRAM RELATED INVESTMENTS

1. Reason for Expanding Parameters

- Many charities have significant investment assets that are not being used directly in their own charitable programs
- For instance, in 2009, charitable foundations had approximately 34 billion dollars in capital assets
- These assets could provide a large financial base for charitable programs for other charities if they could be structured as program related investments (PRIs) that would be considered as part of the charitable expenditures of the investor charity

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- In essence, PRIs by investor charities would free up resources of investor charities that would otherwise be locked up in investments in order to, in part at least, fund charitable programs of other charities
- CRA has permitted PRIs since 1999 as explained in their Community Economic Development policy ("CED Policy") but only on a limited basis
- CRA is apparently considering possible expansion of PRIs at the present time
- What follows is a discussion about possible means of expanding PRIs
- The changes discussed below are primarily administrative in nature as opposed to legislative

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2. The Nature of Program Related Investments

- Instead of a charity investing its assets in the market place to earn income and thereby preventing those assets from becoming available for charitable programs, a charity would be permitted to make loans, loan guarantees and other forms of investment in order to further the charitable purposes of the investor charity
- The most common example of PRIs is in the area of micro-finance where they are utilized to achieve the charitable purpose of relieving poverty
- However, PRIs can also be used in the context of achieving any head of charity, not just relief of poverty

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- In this regard, it is important to ensure that a PRI falls within the parameters of the charitable objects of the charity
- A PRI is not an investment in the normal sense, in that a PRI is not made in order to provide a financial return for the charity, but rather is a means by which the charity can achieve its charitable purpose
- As such, the usual trust law concepts applicable to investments by charities, as well as under provincial trustee legislation with regards to prudent investment standards, would generally not apply when making a PRI
- A PRI is best described as a charitable activity in the guise of an investment

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3. Recipients of Program Related Investments

- At present CRA's CED Policy only permits PRIs to be made to qualified donees
- However, CRA is apparently looking at whether PRIs really need to be restricted to qualified donees
- In this regard, there is no reason why PRIs should not be expanded to non-qualified donees, provided that the requirements of what is charitable at law are met

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- Such requirements would include:
  - That the resources of the charity are being used exclusively for charitable purposes
  - That the charity retains direction and control over the use of its resources
  - Private benefit is no more than incidental
- The direction and control that would be needed would be similar to what is required by a charity in conducting foreign activities through third party intermediaries

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- This would mean that a charity should be able to make a PRI to a non-profit organization or even to a share capital for-profit corporation if the above mentioned requirements are met
- For instance, a PRI could be made in the form of a purchase of shares in a for-profit bank, provided that the bank agreed that an equivalent amount of investment capital in the bank was made available to pursue micro-finance programs
- Another example would be the purchase of shares by a charity that provides relief of poverty in a for-profit corporation commercially operating a residential apartment building where the corporation agreed that a certain percentage of the units within the apartment building would be used for low income families

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- This approach with non-qualified donees would be similar to what can be done currently with the transfer of funds to non-qualified donees in order to undertake charitable programs under a contract for service or an agency agreement
- The key issue is that with both contracts for service or agency agreements with a non-qualified donee and a PRI with a non-qualified donee, the charity will need to be able to evidence that it is furthering one of its charitable purposes and is able to direct and control the programs being pursued

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3. Possible Forms of PRIs

- The possible forms that a PRI can take should not be limited to a pre-approved list
- Instead, there should be a broad based recognition that a PRI can take any form of investment by the charity, provided that the investment is intended and structured in order to further the charitable purpose of the charity
- As such, a PRI should be able to take the form of, for instance:
  - A loan
  - A loan guarantee
  - A real estate holding
  - A share purchase
  - Micro-lending

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4. The Mechanics of Undertaking a PRI

- First, a PRI would need to fall within the parameters of the charitable objects of the charity
- The charity would then need to develop a policy that would set out, among other issues, the following:
  - The rationalization of how PRIs in general would achieve the charitable objects or purposes of the charity
  - The type of permitted PRIs
  - The criteria for determining when a PRI could be made
  - An explanation of the documentation required, depending upon the type of PRI undertaken
  - The type of monitoring of the PRI that would be required

  - The level of direction and control required when making investments with non-qualified donees
  - The limit, if any, on how much of the assets of the charity can be invested in PRIs
  - The type of return, if any, expected from a PRI
  - What is the exit strategy in the event of default or termination of a PRI
  - What safeguards would need to be in place to ensure that there is only incidental private benefit
- In the event of default or termination of a PRI
  - If a loan, the PRI would be subject to immediate repayment or the loan would be converted into a regular commercial loan

  - In the event of a share purchase investment, the share would need to include a right of redemption or an option to require the purchase of the shares by other shareholders
- In the event of termination of the PRI program, the PRI capital would either be used for other charitable programs of the charity, including other PRIs, or become part of the normal investments of the charity
- Whether or not endowment funds (i.e. where there is a restriction on capital expenditure for a fixed term or in perpetuity) could be used for PRIs would require careful scrutiny of the terms of each endowment agreement with regard to right of encroachment and review of investment provisions

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- With regard to the rate of return, the charity would generally seek a below market rate of return in order to facilitate the charitable purposes, but could seek a rate of return that would help to defray administrative costs, as well as reflecting a loan loss ratio applicable to the particular PRI
- But with regard to micro-finance loans in some geographic areas, the rate of return may need to be above market rates in Canada because of the high administrative costs of such loans

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5. The Limitations Placed on Share Purchase PRIs by Foundations

- Both private foundations and public foundations are subject to restrictions with regards to owning shares which would apply to share purchase PRIs by foundations
- Private foundations are subject to divestment obligations with regards to shareholdings in excess of 20% of shares of a corporation under the excess business holdings rules, including limitations on non-qualifying investment rules
- As well, pursuant to par. 149.1(3)(c) and 149.1(12)(a) of the ITA, public foundations cannot acquire a controlling interest in a corporation

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- However, the controlling interest restriction for a public foundation should arguably be relaxed when a public foundation is making a PRI, since a PRI is an application of charitable resources to pursue a charitable purpose as opposed to making an investment in the traditional sense
- Permitting a public foundation to acquire a controlling interest in a corporation as a PRI would better enable the public foundation to exercise direction and control over the programs to be undertaken by the share-capital corporation in achieving the charitable purposes of the public foundation

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6. Disbursement Quota Related Issues for PRIs

(a) Asset Base for Calculation of the 3.5% Disbursement Quota (DQ)

- The current CED Policy recognizes that a PRI constitutes a charitable activity and permits a charity to deduct the amount of a PRI from the investment assets of a charity for purposes of calculating the 3.5% DQ
- The current CED Policy does not extend this approach to micro-lending
- However, CRA apparently is considering excluding micro-loans from the asset base for calculation of the 3.5% DQ similar to what is done with other PRIs

(b) Lost Opportunity Cost

- At present, the CED Policy permits the opportunity cost, if any, of a PRI to be considered as a charitable expenditure for purposes of meeting the 3.5% DQ
- The opportunity cost is defined by CRA to be the difference between what the charity could earn in T-Bills or GICs and the actual rate of return that the charity is receiving
- However, given the extremely low rate on T-Bills and GICs (1 year at 1.5% or less) the opportunity cost is at present very low

(c) Initial Capital Expenditure

- At present, the CED Policy does not permit the initial capital expenditure of a PRI to count as a charitable expenditure for disbursement quota purposes because the charity still retains ownership of the investment
- There is no indication that CRA is considering changing its policy in this regard at present
- However, there is no reason why the initial capital expenditure in a PRI should not be counted as a charitable expenditure for DQ purposes
  - CRA already recognizes that a PRI can be excluded from the asset base for calculation of the 3.5% DQ because the charity is carrying on its own charitable activities in making the PRI

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- If the PRI is recognized as a resource of a charity in conducting a charitable activity, it is inconsistent to say that the application of those assets does not constitute a charitable expenditure for DQ purposes
- The fact that the PRI still remains an asset of the charity is no different from a charity that makes a charitable expenditure for DQ purposes in constructing a building to carry out its charitable purposes (ie. a church building a sanctuary, which structure will remain an asset of the church) notwithstanding that the capital outlay was initially counted as a charitable expenditure for DQ purposes

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- If a specific PRI comes to an end, the capital of the PRI either is moved into another PRI or it is removed as a PRI and becomes part of the investment base of the charity that is subject to the 3.5% DQ calculation

– A PRI should not be treated any differently from any other capital asset of a charity utilized in fulfilling its charitable purpose

– To do otherwise would be to discriminate administratively between different types of charitable expenditures

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C. TAX ENHANCED CHARITABLE LOANS

1. The Rationale for Tax Enhanced Charitable Loans

- The public cannot make equity investment in charities because charities are not share-capital corporations in which the public can acquire an equity interest
- In any event, it would not be appropriate to do so given the prohibition at common law on private benefit emanating from charities
- The public have always been able to make loans to charities, but there has been little incentive for them to do so because the rate of return tends to be below market rates

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- As well, if the loans are interest-bearing, the interest earned would form part of the investor's income and be subject to income tax
- Where loans to charities are made in conjunction with tax driven investments (for example as a part of a RRSP investment involving a mortgage back certificate program), they tend to be complicated investment vehicles and are therefore not very attractive to either the charity or the potential investors because of the complexity of the arrangement and the administration

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- A reasonable and easy to understand tax incentive to encourage investors to make loans to charities could significantly increase the source of financing for charities
- Such an incentive could be an alternative option for investors who are not able to donate their investment funds but are prepared to receive a lower return knowing that by doing so they would be benefitting a charitable cause and thereby doing good within society much in the same way that social enterprise is attracting investors in other jurisdictions like the US and the UK

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- However, simply exempting the income earned by investors from tax does not provide an incentive to the investor to charge a lower rate of interest to the charity, although it would be attractive to the investor to make the loan to the charity in the first place
- The suggestion that follows proposes a tax incentive for the investor to charge a lower rate of interest, or no interest at all, as a result of the availability of a tax credit or a deduction in relation to the lost opportunity cost of the interest forgone
- Just as tax incentives are currently offered to businesses to undertake research and development, tax incentives should also be available for investors in charities in order to encourage expansion of charitable programs

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2. Basic Terms of Proposal

(a) Tax Incentive

- For an individual who makes a loan to a charity, the individual would be entitled to claim a tax credit as explained below
- For a corporation that makes a loan to a charity, the corporation would be entitled to claim a tax deduction as explained below

- The tax credit/deduction would be the difference in the interest rate between a prescribed rate at the time of the loan as described below and the actual interest rate charged on the loan, provided that the rate charged is lower than the prescribed rate
- As such, the lower the rate of interest that is charged by the investor, the greater the tax incentive there is to the investor
- The amount of the tax incentive is intended to be balanced so that it would encourage loans but not so much that it would discourage donations

(b) Right to Return of Capital and No Security

- The investor would retain the right to the return of the capital as with any investment, as well as the payment of interest as provided for in the loan agreement
- If the loaned amount was subsequently forgiven, it would be subject to a tax credit/deduction at that time for the full amount of the loan forgiven
- The loan would be non-transferable but would be repayable on death or default
- The loans would not be secured against the assets of the charity

(c) Loan Commitments and Limits

- Minimum length of investment commitment would be five years, but it would be fully open for the charity to repay the loan at any time
- Minimum amount of each loan would be $5,000, and any amount above that, up to $50,000, would be permitted
- A limit of $50,000 per investment is proposed in order to protect investors given the charity would not be offering security to back up the loans

(d) Rate of Return

- The prescribed rate would be equal to the Bank of Canada prime rate (currently 1%) plus a specific rate (possibly 2% or a higher rate) as of December 31st of each year
- No tax credit/deduction would be available unless the actual interest rate charged to the charity is lower than the prescribed rate
- Assuming that the loan was interest free, then there would be a tax credit or deduction for the full amount of the lost opportunity cost of interest forgone
- The tax credit/deduction would be justified because of (1) lower rate of return to the investor (2) asset lock up, and (3) no security from the charity

(e) Securities Legislation Considerations

- The charity would need to comply with provincial securities legislation, which generally would not require either registration or a prospectus, provided that (a) no part of the net earnings of the charity benefited any security holder, and (b) no commission or other remuneration is paid in connection with the sale of the security
- Minimum disclosure requirements, though, would still be necessary in order to protect investors and to outline not only the tax benefits, but also the lack of security in return for the tax credit/deduction, plus a clear warning that there is no guarantee of repayment

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(f) Relaxing Debt Limits on Public Foundations

- To permit public foundations to benefit from tax enhanced charitable loans as charitable organizations would be able to, it would be necessary to relax the ITA prohibition on public foundations incurring debts other than debts for current operating expenses, debts incurred in connection with the purchase and sale of investments and debts incurred in the course of administrating charitable activities as currently provided for in paragraph 149.1 (3)(d) of the ITA
- The current limit, though, on public foundations incurring debt would continue to apply in all other situations

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3. Overall Advantages

- Tax enhanced charitable loans would provide a new source of financing for charities that would be distinct from donations and government grants
- Because the investor would get a larger tax credit/deduction for charging a lower or no interest rate at all, the charity would be able to access an inexpensive source of capital financing
- Five year minimum term for investments would provide a stable source of financing for the charity
- The avoidance of having to provide security to back up a loan would make it easier for a charity to structure and administer the loans

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