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The Disbursement Quota for Charities: Issues to Consider

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2

OVERVIEW

A. What is the Disbursement Quota?

B. How to Comply with the DQ

1. Calculate the DQ Obligation
2. Track Gifts to QDs and Charitable Expenditures
3. Track DQ Shortfalls and Excesses
4. Possibly Ask for DQ Reduction, if Necessary

C. What are the Concerns with Change to the DQ?

D. Key Takeaways

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A. WHAT IS THE DISBURSEMENT QUOTA?

- "Disbursement quota" (DQ) is the minimum amount that a charity must spend on its charitable activities or gifts to qualified donees to ensure that charitable funds are used for charitable purposes and are not simply accumulated indefinitely by charities
- A requirement under the *Income Tax Act* ("ITA")
- The purpose of the DQ
  - Limit excessive or undue capital accumulation
  - Ensure significant resources devoted to charitable purposes and activities
  - Administrative efficiency – via increased transparency/disclosure

1. Brief Timeline of the DQ

1976

- First introduced

1984, 2004, 2010 Reforms

- Significant reforms

2004 Reforms

- Made rules became more complex but reduced the 4.5% DQ to 3.5%

April 19, 2021

- Federal Budget proposes there be a public consultation with charities to potentially increase the DQ and update the tools at the CRA's disposal to enforce the DQ

August 6 - December 2, 2021

- Department of Finance holds "Consultation on Boosting Spending by Charities in Our Communities"

2. What is the Importance of the DQ?

- Calculating whether a charity has a DQ obligation and then complying with any DQ obligation is an essential part of a charity's responsibilities under the ITA
  - Charities need to be aware of requirements and how to calculate their DQ obligation to ensure compliance
  - However, T3010 does not actually show if a charity has met its DQ obligation
  - Continuous failure to meet the DQ may lead to the revocation of a charity's registration
  - Failure to complete T3010 with correct information can give rise to sanctions (suspension of receipting privilege), as well as revocation
- CRA states it is incumbent upon all charities to report and comply with DQ obligations
- Charities need to exercise appropriate due diligence
- Charities should also be prepared for possible additional challenges that may occur if the DQ rate is increased

3. The DQ Calculation

Set out in subsection 149.1(1) of the ITA

3.5% DQ applies to property owned by the charity at any time in the preceding 24 months not used directly in charitable activities or administration

Threshold amounts for the 3.5% DQ:
- $100,000 (for charitable organizations)
- $25,000 (for public and private foundations)

Further details are set out in *Income Tax Regulations* 3701 and 3702

- Also see CRA's "Disbursement Quota Calculation" https://www.canada.ca/en/revenue-agency/services/charities-giving/charities/operating-a-registered-charity/annual-spending-requirement-disbursement-quota/disbursement-quota-calculation.html

7

B. HOW TO COMPLY WITH THE DQ

1. Calculate the DQ Obligation

a) Determine the Asset Base for the DQ Calculation

- The asset base consists of "all or a portion" of property (e.g. investments, land, buildings) owned by the charity that is not used directly in charitable activities or administration for the charity as a whole
- Calculation applies for the preceding 24 months
- Limited guidance about how to prorate in circumstances where a portion of the property is not used for charitable activities, *e.g.* a church rents out a portion of its building to a for-profit day care centre
- A charity may request permission to accumulate funds to make a major expenditure (*e.g.* buying a building) and if approved, the amount accumulated can be excluded from the asset base

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8

b) Average Value Over Set Number of Valuation Periods

- The value of a charity's asset base included in its DQ obligation is averaged over 2 to 8 valuation periods (chosen by the charity) which can only be changed with CRA's written permission
- Example:

Charity A
- 2 valuation periods over two year period (annual valuation)
- Receives $1 million of investment assets in fourth quarter of 2021
- No other assets not used directly for charitable programs or administration in 2020 and 2021

Charity B
- 8 valuation periods over two year period (quarterly valuations)
- Receives $1 million of investment assets in fourth quarter of 2021
- No other assets not used directly for charitable programs or administration in 2020 and 2021

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- Calculation showing different valuation periods:

	Amounts received for periods in 2020				Amounts received for periods in 2021				DQ Base for 2022	DQ Obligation (base x 3.5%)
Charity A, value of property – annual valuation	Period 1: Jan – Dec 2020				Period 2: Jan – Dec 2021				$1 million / 2 periods = $500K	$17,500
	$0				$1 M					
Charity B, value of property – quarterly valuation	Q1: Jan - Mar	Q2: Apr - Jun	Q3: Jul - Sep	Q4: Oct - Dec	Q1: Jan - Mar	Q2: Apr - Jun	Q3: Jul - Sep	Q4: Oct - Dec	$1 million / 8 periods = $125K	$4,375
	$0	$0	$0	$0	$0	$0	$0	$1 M		

- Charity A has a DQ obligation that is 4x greater than Charity B for the same amount of investment assets

c) Apply the 3.5% Calculation

- The average value of property not used for charitable activities or administration of the charity for the 24 months before the beginning of the fiscal year is to be entered on line 5900 of the T3010
  - The applicable amount before the end of the fiscal period is entered on line 5910 in order to calculate the DQ obligations for the following fiscal year
- The DQ obligation is 3.5% of the amount on line 5900

Line 5900 x 3.5% = DQ obligation

11

2. Track Gifts to QDs and Charitable Expenditures

a) Gifts to QDs

- “Qualified Donee” (“QD”) is defined in subsection 149.1(1) of the *Income Tax Act* and includes (among others):
  - A registered charity
  - Government of Canada, a province or a municipality
  - A registered municipal or public body performing a function of government in Canada
- Current law does not allow charities to make gifts to non-QD’s even if those organizations pursue the same purposes as the charity
- If proposed legislation Bill S-216 is enacted, gifts to non QD’s will be possible in furthering the charitable purpose of the charity, provided that “resource accountability” is followed. See Senator Omidvar’s presentation for details
- Enter gifts to all QDs on line 5050 of T3010

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12

b) Gifts to QDs that are Non-Arm’s Length

- Either of two rules will apply when gifts to QDs are made between non-arm’s length charities:

Anti-Avoidance Rule

- A charity that receives a gift from a **non-arm’s length charity** must use 100% of the gift on its own charitable activities or gifts to QDs in the fiscal period the gift was received or in the following fiscal period
- Failure to do so could result in a 110% tax on the unused amount or the revocation of the receiving charity’s registered status

Designated Gift

- Alternatively, the donor charity may make a **designated gift** (a gift that is not counted in meeting the donor charity’s own DQ obligation)
- The recipient charity does not have to spend 100% of the **designated gift** by the end of the next fiscal period

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c) Inter Charity Transactions to Avoid

- Anti-avoidance rules expanded to include situations where a registered charity entered into a transaction (which may include an inter-charity gift) where it "may reasonably be considered that a purpose of the transaction was to avoid or unduly delay the expenditure of amounts on charitable activities"
- Applies regardless of whether the two charities are at arm's length
- 110% penalty applies
- If an inter-charity transfer is involved, both charities are jointly and severally, or solitarily liable for the penalty
- Both charities risk revocation

d) Charitable Expenditures

- Expenditures on charitable activities include (per CRA):
  - Running a charity's day-to-day programs
  - Occupancy costs (such as rent, mortgage payments, hydro, repairs, and insurance) for the building(s) used to carry on charitable activities
  - Most salaries
  - Education and training for staff and volunteers
- Do not include expenditures for management, administration or fundraising
- There can be an allocation when there are expenditures that are considered partly charitable and partly management and administration, provided that such allocation is done consistently and on a reasonable basis
  - Keep track of those allocations throughout the fiscal year
- Enter the amount of all charitable expenditures on line 5000 of the T3010

15

e) Program Related Investments

- Program Related Investments ("PRIs") are impact investments or social investments that directly further the investor charity's charitable purpose
  - *E.g.* purchase of shares in a micro finance bank to achieve charity's purpose of relief of poverty.
- PRIs used for charitable activities are not included in a charity's asset base for calculating the DQ obligation
- However, PRIs are generally <u>not</u> considered by the CRA to be a charitable expenditure and therefore do not count toward meeting the DQ obligation, except in limited circumstances where:
  - Unable to recover part or all of the principal of a PRI
  - Lost opportunity cost (*e.g.* lost income)

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16

3. Track DQ Shortfalls and Excesses

DQ Excess

- Occurs when a charity spends more on charitable activities or gifts to QDs than its DQ for that year
- Can be carried forward for five years or carried back one year

DQ Shortfall

- Occurs when a charity spends less on charitable activities or gifts to QDs than its DQ for that year
- Can be met using excess from past five years or from next year
- Continuous shortfalls may lead to revocation of a charity's registration.

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17

4. Possibly Ask for DQ Reduction, if Necessary

- If a charity is not able to meet its DQ after applying available excess from previous five years or creating a DQ excess in the next year and carrying it back a year, it may apply for a reduction from the CRA
- Reduction, though, is available only where the shortfall is due to circumstances beyond a charity's control
- Generally, a charity will not receive approval from the CRA until the information return for the following fiscal period is received by the CRA
- If a reduction is granted, the charity must amend its T3010 to include the reduction on line 5750

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18

C. WHAT ARE THE CONCERNS WITH CHANGE TO THE DQ?

1. Insufficient Data

- The T3010 offers an incomplete picture on whether the DQ has been met by a charity in any given year
- Is there sufficient data to show that increasing the DQ will result in more funds to the community?

2. Overly Complicated Compliance

- Old (pre-2010) versions of the DQ rules were very complicated and imposed a large administrative burden on charities
- Will new DQ rules be challenging for charities to calculate or follow?

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3. Terms/Restrictions of Endowment

- Need to be mindful of terms/restrictions of endowment funds held by charities
- What if endowment funds held by charities do not permit encroaching capital or realized capital gains?
  - If investment returns is less than the DQ%, can charities encroach on capital or realized capital gains?
  - Some endowments are structured by donors to prevent the charities from encroaching on capital or realized capital gains – will require court order to allow the charity to dip into capital or realized capital gains to meet DQ
  - Court applications are costly and time consuming, and no guarantee courts will grant the order sought

4. Low Investment Market Return

- Charities may opt for a higher risk / higher return investment strategy to generate more income, but they must ensure they continue to comply with the “prudent investor” standard in provincial trustee legislation (*e.g.* Ontario’s *Trustee Act*)

5. DQ at Fund vs Charity Level?

- Will DQ need to be met at the fund (asset) level rather than at the charity level?
- If so, there would be a large administrative burden for some charities that hold hundreds of individual funds
- Funds may be subject to donors’ restrictions, which may create complexities in tracking which funds will require court authorized relief from restrictions on expenditures of capital or realized capital gains

D. KEY TAKEAWAYS

- Calculating whether the charity has a DQ obligation and then complying with any DQ obligation is an essential part of a charity's responsibilities under the ITA
- Correctly completing the T3010 with required information is an important obligation of the charity
- Given the high public profile nature of the DQ consultation by the Department of Finance, the CRA may need to give greater scrutiny to DQ compliance on audits
- Charities need to be aware of some of the nuances of the DQ calculation, such as valuation periods, anti-avoidance rules, and DQ shortfalls & excesses
- If changes are made to the DQ rate, charities should take proactive steps to identify challenges that may occur and find ways to address any shortfalls

Select Resource Material of Submissions to Finance, re: DQ

- Carters (Charity & NFP Bulletin 498)
  https://www.carters.ca/pub/bulletin/charity/2021/chylb498.pdf
- Canadian Bar Association – 2 submissions
  https://www.cba.org/CMSPages/GetFile.aspx?guid=a8cc9301-1546-4097-b9ce-c95dbd4b28fa
  https://www.cba.org/CMSPages/GetFile.aspx?guid=d792277a-1f41-4174-aa54-e2ad00a53c31
- Advisory Committee To The Charitable Sector
  https://www.carters.ca/pub/article/charity/2021/ACCS-Submission.pdf
- Imagine Canada
  https://imaginecanada.ca/sites/default/files/disbursement-quota-submission-Imagine-Canada.pdf
- Pemsel Foundation (research series)
  https://www.pemselfoundation.org/disbursement-quota-research-series/

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