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**SPRING 2021 CHARITY &  
NFP WEBINAR SERIES**  
*VIRTUAL – May 4, 2021*

**DONOR ADVISED FUNDS:  
AN OVERVIEW AND LEGAL  
IMPLICATIONS**

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 <p>BARRISTERS SOLICITORS TRADEMARK AGENTS</p>	<p><b>CARTERS SPRING 2021 CHARITY &amp; NFP WEBINAR SERIES</b> Tuesday, May 4<sup>th</sup>, 2021</p>
<p><b>Donor Advised Funds: An Overview and Legal Implications</b></p> <p>By <b>Jacqueline M. Demczur, B.A., LL.B.</b> jdemczur@carters.ca 1-877-942-0001</p> <p>© 2021 Carters Professional Corporation</p>	
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## OVERVIEW OF TOPICS

- Introduction
- History, Development, and Current Size of DAFs
- What is a DAF at Law?
- Current Issues Associated with DAFs
- How to Work with DAFs
- Conclusion

For more information, see the May 6, 2019 paper, "Primer on Donor Advised Funds and Current Issues":

<https://www.carters.ca/pub/seminar/charity/2019/Paper-Primer-or-Donor-Advised-Funds-and-Current-Issues-Jacqueline-Demczur-2019-05-06.pdf>

## A. INTRODUCTION

- Donor Advised Funds ("DAFs") have garnered much attention over the last few years
- DAFs that are properly set up and operated can be helpful in facilitating gifts for the charitable sector
- The flexibility in structuring DAFs is one reason why their use has grown significantly in Canada over the last 20+ years
- However, misconceptions exist about what DAFs are at law, how they are legally established and administered, and the level of donor control over them
- If DAFs are not operated properly, they may continue to generate unnecessary scrutiny from regulators

## B. HISTORY, DEVELOPMENT AND CURRENT SIZE OF DAFs

### 1. What is a DAF Anyway?

- A DAF is a type of charitable giving vehicle, established when a fund is created by a donor through an initial donation to a registered charity (“DAF charity”)
- The gift by the donor is irrevocable, and the donor receives a charitable donation receipt from the DAF charity in exchange for the gift
- Donations to a DAF charity can be cash, securities or other investments, insurance proceeds, or bequests
- Income generated by the capital in a DAF is gifted to qualified donees (most often to registered charities)

- The donor is given the unique role of making non-binding suggestions to the DAF charity regarding distribution of assets from the DAF to other charities
- However, despite this donor advice, all administrative, operational, and governance matters, including compliance with the *Income Tax Act (Canada)* (“ITA”) and the policies of the Canada Revenue Agency (“CRA”), are the sole responsibility of the DAF charity
- All parties involved in a DAF should understand how DAFs work, both legally and functionally, in order to avoid unexpected problems or challenges in the future

## 2. History, Development and Current Size of DAFs

- 1931 & 1952: First DAFs established in community foundations in the US and Canada, respectively
- 1991: Fidelity Charitable Gift Fund established in US
- 2004: Financial services firms in Canada start establishing DAF-holding foundations
- 2006: ITA amendments eliminate capital gains tax on donations of publicly traded securities to charitable organizations and public foundations
- 2007: These ITA amendments are extended to private foundations
- This leads to growth in the number of public/private foundations focused on holding DAFs

- In Canada in 2016, there were an estimated 10,700 DAFs holding \$3.2 billion CAD in assets, with an average account size of \$300,000 CAD average fund
- By 2018, the number of estimated DAFs had grown to 15,765 holding \$5.7 billion CAD in assets, with \$356,000 CAD average fund account size
- Of note, faith-based DAFs have grown from an estimated \$1.573 billion CAD in 2016 to approximately \$1.967 billion in 2018
- The flow rate (grants/donations) for DAFs was 65.6% in 2017 and 85.5% in 2018
- DAFs expected to continue growing in popularity in Canada, with projected potential to reach \$7.5 billion CAD (2023), and then \$9.5 to \$10.3 billion CAD (2026)

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### 3. Who are the Key “Players” in DAFs?

a) Donors

- Various factors determine which charitable giving method is best, e.g. source of funding for gift, gift size, timing, and the type of charity the donor wishes to support
- It is generally thought that donors are attracted to DAFs because of their desire for ongoing “control” over DAF assets and their flexibility
- An added feature of DAFs is the relative anonymity that they provide to donors, with the DAF charity acting a “buffer” between the donor and qualified donees seeking donations, as well as the general public and sector watchdogs

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### b) DAF charity (often called “Sponsors”)

- All are registered charities
- Community foundations
  - Focused on raising monies from donors in particular geographical community
- In-house foundations of financial institutions utilized to make DAFs available to clients of the institutions
  - Financial institutions include large banks, credit unions, mutual funds and financial services firms
- Independent DAF charities
  - Registered charities not directly affiliated with a financial institution which are established to exclusively offer DAFs

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- Single issue focused charities
  - Established to receive and hold DAFs for benefit of particular sector, *i.e.* religious organizations, higher education facilities, etc.

### c) Registered charities

- Gifts from the DAF charity must be given to a qualified donee, usually registered charities
- Can be challenging to apply for grants directly from DAFs, but some DAF charities are now developing grant application systems

### d) The CRA

- Regulator of registered charities

### e) Others, e.g. financial advisors and financial institutions

- Clients interested in establishing a DAF will often follow advice of their financial advisors on which charitable foundation to use
- Financial advisors may receive bonuses for these initial client referrals, as well as based on the ongoing amount of assets in the DAFs
- Financial institutions (with in-house foundations or partnerships with independent DAF charities) provide investment services for the DAF assets held by a DAF charity, resulting in management and investment fees

## 4. Why are DAFs so Popular Now?

- DAFs may be a practical and appealing alternative for donors who do not have the ability, interest or time to operate their own private family foundations
- Donor is not involved with burden of establishing and managing the DAF, but can still have ongoing advisory role
- Relatively inexpensive to establish a DAF in comparison to a private foundation, so it is accessible to a greater number of potential donors
- DAF donors may enjoy the ability to remain anonymous, given that the DAF charity is interfacing between them and recipient charities of gifts from the DAFs

## C. WHAT IS A DAF AT LAW?

### 1. What is a Charitable Gift?

- A gift is a voluntary transfer of property to another without compensation
- Two main types of gifts under common law:
  - *donatio mortis causa* (gifts made in prospect of death);
  - *inter vivos* (gifts made during one's lifetime)
- Three conditions to be met for an *inter vivos* gift:
  - It must be made voluntarily by the donor
  - There must be a transfer of property by the donor
  - The donor must not receive any consideration for making the gift



- For a gift to be voluntarily made, the donor must have clear intent and the requisite capacity to make a gift
  - Gift must be real or personal property
  - Donor cannot be legally obligated or coerced in making the gift
- Property must be transferred or delivered
  - Use a deed of gift or similar documentation, signed by both parties, to evidence the gift
  - Other actions may be required, e.g. registering shares or title of real property, physical delivery of a tangible asset
  - Acceptance of a gift is generally presumed upon delivery

- The donor cannot receive any consideration for the transfer of property
  - Donor cannot retain control or possession of gift once it is given to recipient
  - Excessive ongoing control by donor over the gifted property may defeat or negate the gift
  - Any input provided by the donor over the use or management of a DAF must be completely non-binding
  - Only exception to this is the split receipting rules under the ITA
- The disqualification of a gift may have serious implications under tax law

## 2. What is a Donor-Restricted Charitable Gift?

- Unrestricted charitable gifts must be applied by a charity to its charitable purposes, and are not subject to any other donor restrictions
- Restricted charitable gifts are subject to “restrictions, limitations, terms of reference, directions, or other restricting factors” imposed by the donor that limit the charity’s ability to use the gift
- A charity’s board must identify the nature of these restrictions, recognize the legal consequences of them, as well as ensure compliance with such restrictions
- Failure to do so may potentially expose the charity and its board to allegations of breach of trust

- Special purpose charitable trusts (“SPCT”) are a type of donor-restricted charitable gift, where gifts are held by a charity in trust for a specific charitable purpose
- Donor-imposed restrictions on SPCTs could involve:
  - A time restriction, *e.g.* the capital of the gift to be held for perpetuity
  - A use restriction, *e.g.* where the gift is to be used for specific charitable purpose such as research into a particular disease
  - Both time and use restriction, *e.g.* endowment where the capital is to be held in perpetuity, and the income used for a specific charitable purpose
- A gift subject to a SPCT is not owned beneficially by the charity, but is essentially a charity within a charity

### 3. What is a Gift for Income Tax Purposes?

- Donors seeking tax benefits need to ensure donations are gifts at common law and under the ITA
- The CRA has adopted the traditional common law definition of a gift
- However, gifts for income tax purposes are not necessarily the same as gifts at common law. For example, under the ITA:
  - Gifted property cannot include services, free accommodation, free use of real property, or pledges of property
  - Split-receipting rules permit donors to receive some consideration in exchange for the donation
- Only gifts that meet ITA requirements can be properly received by a registered charity

- Improper receipting can potentially lead to:
  - CRA sanctions and penalties
  - Revocation of charitable status
  - Potential designation of directors and senior management as ineligible individuals
  - Poor donor relations, and
  - Bad press
- If the registered charity that issued a official donation receipt later returns the gift, the charity must file an information return with CRA within 90 days after the day of return, and provide copy of the return to the donor
- If a gift is found to fail, the CRA will reassess the donor's income tax returns that relied on the donation receipt for the invalid gift

#### 4. How Does This All Relate to a DAF?

- DAFs are distinct funds within structure of DAF charities
- The original gift from the donor establishing a DAF could be unrestricted or, alternatively, subject to one or more donor restrictions, *e.g.* how long capital to be held or how income is to be used
- The uniqueness of a DAF relates to the donor advised “feature” impressed on the gift at its inception, *i.e.* the ability of the donor to offer ongoing “advice” to the DAF charity on one or more aspects of the DAF
- However, while the DAF charity may have a contractual obligation to consult the donor on agreed upon DAF issues, this feature is not a donor restriction *per se*, meaning a DAF on its own is not a SPCT

- That said, the DAF charity has both practical and moral obligations to follow donor advice
- For a DAF charity, the key issue is that the ownership of the DAF funds belongs to the charity, not the donor
- Given this, donors must be clearly informed from the outset that their input is advisory only and all DAF fund decisions are made by the charity
- This is imperative to do in order that all DAF donations will be true gifts at law and then properly receiptable under the ITA
- Where there is excessive on-going control by the donor over a DAF, then the CRA may consider the gift(s) to the DAF to be defeated or negated

- Gifts are made from DAFs by the DAF charity to qualified donees (“QDs”) under the ITA, usually registered charities
- DAF charities will need to list all of these gifts to QDs in their T3010s
- Since a DAF charity serves as an intermediary between the DAF donor and the recipient charities of gifts, there is often no direct contact between the donor and these recipient charities
- This may cause uncertainty for operating charities in securing ongoing and consistent donation streams, although it provides a level of privacy for DAF donors

## D. CURRENT ISSUES ASSOCIATED WITH DAF’S

### 1. Disbursement-Related Issues

- The disbursement quota (“DQ”) is the minimum amount that a registered charity is required to spend each year on its own charitable programs or on gifts to QDs
- Whether a DAF charity meets the 3.5% DQ requirement under the ITA is determined on an aggregate basis, as opposed to a fund-by-fund basis
- There is some concern that DAF charities may “sit on” certain DAF assets indefinitely if the DAF charity can meet its DQ through other disbursements, thereby diverting significant assets from the charitable sector

- It is important to recognize that there are no known abuses of DAFs to date in Canada
- Many DAF charities have their own internal minimum annual disbursement policy requirements
- Despite this, suggested options to regulate DAFs are:
  - Requiring minimum disbursements for each DAF to ensure DAF assets are actually gifted to QDs
  - Selectively imposing a different DQ rate on DAFs either alone or on all donor restricted charitable funds held by registered charities
- Careful study of these issues is necessary before any steps are taken
- Quick action to remedy one perceived problem may significantly impact the broader charitable sector

- In this context, the June 2019 Report of the Special Senate Committee on the Charitable Sector, Catalyst for Change: A Roadmap to a Stronger Charitable Sector (the “Report”), provided 42 recommendations to the Government of Canada, including:
  - **Recommendation 36** to direct the Advisory Committee on the Charitable Sector (“ACCS”) to examine the advantages and disadvantages of amending the DQ for registered charities; and the advantages and disadvantages of setting the DQ in regulation, rather than statute
  - **Recommendation 37** to instruct the ACCS to consider means of ensuring that donations do not languish in DAFs, but are instead used to fund charitable activities in a timely fashion

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Advisory Committee on the Charitable Sector  
Federal Budget 2021

- These recommendations were supported by the Minister of National Revenue’s letter of March 30, 2021 in response to the Report, which stated that the CRA would ask the ACCS to review these issues
- The ACCS was established in 2019 as a consultative forum for the Government of Canada to engage in meaningful dialogue with the charitable sector, advance emerging issues relating to charities, and ensure the regulatory environment supports the important work that charities do
- Recent Federal Budget 2021 proposed launching public consultations about potential DQ increase beginning in 2022
  - Charities need to monitor the progress and outcome of these public consultations

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## 2. Lack of Transparency and Accountability

- There is some concern over whether there is lack of transparency and accountability associated with DAFs
- One suggestion to address this issue is to require DAF charities to include extra information on their annual charity information returns (T3010), e.g.:
  - Number of DAFs held by the charity in the year
  - Total value of assets held in the DAFs, as well as total distributions to QDs, both individually and collectively
- However, it is unclear if such additional reporting requirements are appropriate or even necessary
- Careful study of such proposals should be undertaken before a final determination is made

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### 3. Conflicts of Interest

- There are also concerns where the DAF charity is linked to a financial service firm that offers financial and investment services related to the DAFs for a fee, resulting in potential conflicts of interest
- A donor would usually liquidate a portion of its investment portfolio managed by a financial services firm in order to make a regular charitable gift
- However, where the gift is made to a DAF charity, it usually results in the linked financial services firm continuing to manage the DAF funds
- The DAF charity's fees typically are based on the amount of assets under management ("AUM"), which may create an incentive to distribute DAF funds to the charitable sector more slowly

### 4. Are Some DAFs Really Gifts at Law?

- One of the more pressing concerns regarding DAFs is how much ongoing control a donor can have over the DAF after the gift is made
- A "selling point" of DAFs in some marketing communications is that they allow the donor to have the perception of ongoing "control" over who receives disbursements from the DAFs, the amounts and timing of disbursements, and even how the assets are to be managed or invested
- There can be a "disconnect" between how DAFs legally work versus how they work functionally
- Too much donor control over the DAF after the gift has been made begs the question of whether there is legally a gift, and if it is receiptable under the ITA



## 5. Monies Transferring to DAFs

- Another concern is that DAF monies could be continually circulated to or between charities and, therefore, not be used to conduct real charitable work
- However, the ITA and CRA have anti-avoidance rules to address this issue
  - A charity who receives a gift from a non-arms' length charity must spend 100% of the gift's fair market value: (1) on its own charitable activities or (2) to make a gift to an arms' length QD in the year the gift was received or the following year
  - If the charity does not spend that amount within a prescribed time, it may be subject to a penalty or even revocation of registered status

- Alternatively, the donor charity could designate its gift in accordance with ITA requirements, resulting in the recipient charity not being subject to these additional spending requirements
  - Designated gift – a gift made between registered charities that are not at arms-length
  - To designate a gift, the donor charity indicates that the gift is a designated gift in its T3010 for fiscal year in which the gift is made
  - However, it is important to be aware that the donor charity cannot use the amounts of any designated gifts to satisfy its own DQ requirements in that year

## E. HOW TO WORK WITH DAFs?

### 1. Properly Establishing and Managing DAFs

- Difficulties with DAFs may arise from a lack of legal understanding of a DAF, *i.e.* what it is at law and how to legally operate a DAF, or if there is a failure of both charities and donors to implement appropriate practices in daily operation of the DAF
- Ownership of DAFs and its assets must be held by the DAF charity and it must retain control over all decisions
- DAF charities must take all necessary steps to appropriately advise donors, initially and on an ongoing basis, on the advisory nature of donor input

- Documents creating a DAF must clearly state that
  - It is the DAF charity which administers the fund
  - The DAF charity reserves the right to not follow advice of the donor regarding how monies in the DAF are to be distributed or applied
- Gifting agreement could also address:
  1. Name of the DAF
  2. Minimum amount required to establish the DAF
  3. Amount of time that donor has to contribute gifts to reach this minimum amount, and what happens if the minimum is not achieved by donor
  4. Any donor restrictions to be imposed at the outset on the DAF, *i.e.* time and/or use restrictions

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5. Frequency of gifts to be made from the DAF, and the minimum amounts for these gifts per year
6. General parameters for the types of QDs to be recipients of DAF gifts
7. Frequency of and how donor's advice will be sought
8. If and how a donor is permitted to appoint a successor advisor to the DAF
9. Any special investment powers that the DAF charity has in relation to the DAF assets, or that the donor wishes to impose at time of making gift(s) to the DAF charity
10. A requirement that donor's advice (but not approval) be sought if the DAF charity decides to transfer the DAF to another charity under the *Trustee Act* (Ontario)

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- Gifting agreement should originate from the DAF charity, be thoroughly reviewed with the donor who should also obtain independent legal advice, and then be signed by both parties
- The charity must properly manage its DAFs by ensuring:
  - compliance with donor restrictions, as well as donor advice and reporting requirements, in gift agreement
  - the DAF is tracked and managed separately from other DAFs or donor restricted trust funds
  - investment of each DAF's assets is done in accordance with either the gift agreement or, if it is silent, then its own general investment powers

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- the DAFs and any restricted funds are not commingled with general funds for investment purposes
- any proceeds from a sale of charitable property held in the DAF are impressed with the original donor restrictions imposed at the time the DAF was established, if any, as well as the donor advised “feature”
- any transfer of a DAF to another charity must be done using written appointment pursuant to s.3 of the *Trustee Act* (Ontario)

## 2. Practical Advice in Establishing DAFs

- Do your homework! If DAFs cannot be established/administered legally, they should not be done at all
- Charities need to take the time, do all necessary due diligence and seek legal advice to understand how to establish DAFs correctly from the outset and advise their donors accordingly
- Some key due diligence steps include:
  - develop and implement written gift acceptance policies addressing DAFs and other gifting vehicles
  - utilize checklists to ensure consistent treatment
  - encourage clear communication with donors before gifts to DAFs are made

- prepare appropriate DAF gift agreements
- ensure that your charity knows how to manage/administer DAFs correctly in accordance with ITA obligations
- Create templates – provide advice to the charity on how to create appropriate template documents that allow it to receive gifts through DAFs
- Ensure that the charity runs the process – it, together with its legal counsel, not the donor and their legal counsel, should be in control in establishing DAFs, utilizing consistent procedures as set out in a policy and the applicable gift agreements

- Be vigilant – advise charity of potential issues regarding DAFs and ways to mitigate these risks, *e.g.*:
  - avoid referring to DAFs as “accounts”
  - avoid referring to donors as “clients”
  - avoid engaging in marketing/communications that suggest a DAF “belongs” to the donor, the donor makes all decisions in relation to the DAF, or the DAF is the donor’s own “private foundation”

## F. CONCLUSION

- DAFs that are properly set up and operated can be very helpful in facilitating gifts for the charitable sector
- However, both charities and donors should clearly understand the legal requirements of DAFs before getting involved in them
- A DAF that does not comply with all legal requirements may potentially invalidate any gifts made to it, which would then preclude (or later invalidate) any charitable donation receipt issued for these gifts
- DAFs will continue to grow in number and value, so charities and donors, together with their legal counsel, need to be aware of their legal underpinnings and how to operate them properly

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