Budget 2021 – Charities and the Disbursement Quota: The Issues

The Pemsel Case
FOUNDATION

"The law of charity is a moving subject"
– Lord Wilberforce

About Us

Named after the 1891 House of Lords decision, *Commissioners for Special Purposes of the Income Tax v. Pemsel*, [1891] A.C. 531, which established the four principal common law heads of charity used in Canada and elsewhere, The Pemsel Case Foundation is mandated to undertake research, education and litigation interventions to help clarify and develop the law related to Canadian charities. The Pemsel Case Foundation is incorporated under the *Alberta Societies Act* and is a registered charity.

The Pemsel Case
FOUNDATION

Suite 1150, 10060 Jasper Avenue,
Edmonton, Alberta, T5J 3R8

www.pemselfoundation.org

Budget 2021 – Charities and the Disbursement Quota

The Issues

1. Introduction

In the 2021 budget, the federal government announced that it would explore whether the disbursement quota that applies to charities should be increased.

The budget stated:

> *Every year, charities are required to spend a minimum amount on their charitable programs or on gifts to qualified donees. This is known as the "disbursement quota" and it ensures that charitable donations are being invested into our communities.*
>
> *While most charities meet or exceed their disbursement quotas, a gap of at least $1 billion in charitable expenditures in our communities exists today. Furthermore, growth in the investment assets of foundations has increased significantly in recent years. In 2019, charitable foundations held over $85 billion in long-term investments. But grant-making and other charitable activities have not kept pace.*
>
> *Budget 2021 proposes launching public consultations with charities over the coming months on potentially increasing the disbursement quota and updating the tools at the Canada Revenue Agency's disposal, beginning in 2022. This could potentially increase support for the charitable sector and those that rely on its services by between $1 billion and $2 billion annually.*

The disbursement quota is set at 3.5% of the value of a charity's assets not used for charitable activities or administration.

On August 6, 2021, the Department of Finance announced its consultation process that will take place largely through electronic submissions.

The Pemsel Case Foundation prepared this report to aid in the discussion of the issues under consideration. It also informs Pemsel's response to the questions posed by the Department of Finance in its consultation document and is contained in Appendix "A" to the report.

2. Why Changes to the Disbursement Quota Matter

This issue has implications for both charitable foundations and charitable organizations.

As the budget suggests, a change in the disbursement quota will affect how much charities spend.[1] In the budget, the focus is primarily on foundations, both private and public. Many foundations have an endowment. The capital of the endowment is invested, and the income earned from those investments is used to make grants to charities, carry out charitable activities and pay for the costs of operating the foundation.

If the disbursement quota is increased, some of these foundations would have to spend more money (on grants, charitable activities they operate directly, or administration) than they do.[2] Some of this spending would go to grants, so additional resources might be available to charities and other qualified donees; whether this would translate to the additional $1 billion to $2 billion cited in the budget document is much less certain.

A change in the disbursement quota could also affect how foundations invest their endowments. A higher disbursement quota could mean they have to take more risks to earn enough income to meet the higher disbursement quota. Higher risk means that these foundations could lose money, reducing the size of their endowment and the money they would have to spend.

Nothing in the existing law limits how much a foundation may spend. The disbursement quota represents a “floor” for spending, not a “ceiling.”

Indeed, many foundations spend more than the minimum 3.5% each year.

The 2021 Budget and the Finance consultation documents state the growth in charity investments and the pace of charitable spending are not in balance. Little data is provided to support this claim which leads one to ask whether it is correct. Before any change is made to the disbursement quota rate, better data is needed to understand the basis for any change and whether a rate change is the best solution to correct any alleged imbalance. The analysis we provide illustrates the problem. Readers of the T3010 can tell what charities spend if charities complete various lines on the T3010. But what we don’t know is how total spending relates to their DQ. As a result, the nature and reasons for any shortfall or over contribution can’t be known. Without this better information, nobody can determine whether a change in the disbursement quota rate is the proper policy response to the concerns raised by the government.

[1] Implicit in some comments seeking an increase is a notion that charities are simply not spending. The implication is that the current disbursement quota rate means there is less charity. The unstated premise is that more spending today also means more spending tomorrow.

But it is not a zero-sum game in which all else is equal. More spending today does not mean more spending. It simply means more spending today, which unless donations increase to match the expenditure rate, presumably entails less spending tomorrow.

[2] This is not universally true. Many foundations already report eligible spending that exceeds the disbursement quota.

Given the outcome identified by the government, it is fair to ask for detail about:

- current aggregate expenditure levels for the sector, how that figure is calculated, and how it relates to the current quota mechanism;

- assuming the calculation is based on the T3010, what is the quality of T3010 data;
- how active the Canada Revenue Agency (CRA) is in enforcing the current DQ and how much additional funding might be generated if the CRA were to increase compliance efforts;
- the need for additional compliance tools needed to enforce the DQ; and
- how can the government ensure that an increase to the DQ will result in additional funds flowing to those front-line charities that are cash-starved?

There should be a periodic review of the DQ. If a change is warranted, based on markets and improved data, it should be implemented.

3. A Brief History of the DQ

In part 2 of this series of publications, Carl Juneau outlines the history of the disbursement quota. Knowing the history is critical to any conversation about changing the rate.

The disbursement quota recognizes that people and organizations that create foundations obtain certain tax benefits, and thus, the assets of those foundations should serve a public benefit. Money should not be left to accumulate and languish.[3] As Juneau's paper explains, there are also several other reasons to make sure foundations actively engage in charitable work.

When the disbursement quota was last adjusted in 2004 — reduced to 3.5% from 4.5% — it followed a study of long-term investment returns. If that analysis was done before the 2021 budget announcement, the data have not yet been publicly shared.

4. What Available Data Tell Us, and Don't Tell Us About This Issue

In part 3 of this series of papers, we set out findings based on data obtained from the annual T3010 return every charity must file. What is readily apparent is there is insufficient data to lead to an evidence-based conclusion about the impact of the disbursement quota on foundations or the broader charitable sector. Again, if the federal government has additional information, it has not yet been made public, not even what assumptions were made that led to its statement that a change in disbursement quota would cause $1 billion to $2 billion more funding being available to charities.

Many of the problems with this data are the fault of charities themselves. The analysis shows significant errors and missing information in the T3010 data. This makes any conclusions

[3] That said, raising the disbursement quota rate isn't simply about economizing tax expenditure. Even if it were, today's endowments were not entirely subsidized by today's taxpayers. Accumulated endowments were subsidized by yesterday's taxpayers in anticipation of charitable programming being funded through endowments across generations. If we must talk about value for foregone tax revenue, we need to at least acknowledge that the value proposition applies to taxpayers from yesterday, today and tomorrow (not just today).

somewhat meaningless. We are also not aware of any analysis of the average growth rate of foundations' assets. Even the chart in the Budget, showing the growth of foundations, does not provide those calculations, nor does it identify what amounts are attributable to new foundations, or the significant skewing of assets because of one foundation, the assets of which overshadow, by an order of magnitude, the assets of any other foundation in the country.

The T3010 information doesn't allow CRA — or the public — to determine for any year whether a charity is meeting its disbursement quota. In a majority of cases a key piece of information used to determine the disbursement quota is missing. [4] Also, the reporting form does not ask a charity to report whether it is using a "disbursement excess" from a previous year to reduce its spending requirements for the current year. Again the result is CRA and the public cannot rely on the reporting form to calculate which charities have met their disbursement quota, and which have not.

Another key piece of missing information is what government has done to enforce the existing disbursement quota. The Budget statement talks about providing the CRA with additional "tools". It is impossible to respond about additional tools, without information about the use of existing ones and if they are effective.

CRA already has tools available to it. If a charity fails to file a complete or accurate return, its receipting privileges can be suspended until that is corrected. If a charity fails to meet its disbursement quota, its registration as a charity can be revoked. Further, the current compliance regime provides tools which would permit CRA to nudge a charity towards compliance. The education-first approach permits CRA to educate the charity to bring it into compliance. Or where the mischief is more significant, the law permits CRA to propose a compliance agreement where if the charity did not make up the shortfall or failed to meet its DQ obligations it could be sanctioned, including losing charitable status. In other words, it would appear there are sufficient tools for CRA to use. Additional tools do not seem to be necessary, but may be required if there are patterns of abuse. But on the available data, the need for additional tools is not shown.

We are not aware that CRA has ever moved to revoke the registration of a charity solely (or even primarily) because it has failed to meet its disbursement quota. Nor is there any indication on the CRA list of charities that a charity has faced an intermediate sanction for filing an incomplete or inaccurate annual return.

The T3010 design fails to gather needed information. The design is within the exclusive authority of CRA and its Minister. Before contemplating new tools, prudence dictates we examine what is already available and how CRA could gather the evidence needed to use the available remedies. Adding additional penalties — without more enforcement than now exists — would not be productive.

There is little information publicly available about the investment practices of foundations or the impact on those practices if a higher disbursement quota was imposed. While there is readily available information about how various types of investments have performed over long periods of time, we do not know what sort of "model portfolio" would best reflect the reality of foundations, let alone what models of investments they have chosen, often with significant professional advice. As noted earlier, we have no information as to what analysis the Department

[4] Some of the unavailable information might be attributable to charities and some to the T3010 form. Among the issues: 1) Failure of charities to complete line 5900 (including 60% of foundations), the primary basis on which calculating the disbursement quota can be based. And this omission could account for CRA's failure to enforce this requirement); and, 2. The T3010 doesn't have charities disclose any permission to spend less than the disbursement quota. Note, this differs from whether they have permission to accumulate funds.

of Finance has done to examine financial returns since the time of the last adjustment to the disbursement quota. One would have thought this would be a significant piece of information that would inform consultations.

Not every government policy decision will be supported by data. At the very least, however, one would expect that decisions would be informed by the data. That can't happen if the data do not exist, or if they are unreliable — both of which are the case here. Still, government could legitimately conclude that in return for the benefits of charitable registration, some greater amount of money should be expended. The DQ rate should not be changed without consideration of better data. But if a rate change is made, an evaluation framework should be publicly available to assess the impact of that change.

5. What the Disbursement Quota Consultation Should and Shouldn't be About

Since the budget announcement, some people and organizations have sought to include additional topics in the discussion. This serves only to confuse the issue.

The budget states that the consultations will help determine if the 3.5% disbursement quota should be changed. This paper is prepared on that basis and deals primarily with this question.

The budget announcement is **not** about:

- **whether foundations should operate in perpetuity**. Some foundations operate on the basis that they should continue to exist through many generations. Some people argue this should not be allowed, and that foundations should have to disburse all of their assets within a certain number of years. Some say it is not clear that the federal government has the constitutional authority to make such a change. [5] Perpetuity is an important topic. But it complicates more than facilitates analysis of the disbursement quota to approach the matter as one of inter-generational justice. The anti-perpetuity perspective contends today's generation faces pressing problems warranting more current spending. The implication is today's generation is somehow being cheated, saving for a rainy day while weathering a downpour. The problem is many of today's accumulated endowments are the product of yesterday's deferred spending. Prior generations understood charitable purposes as having universal value across time, culture and circumstance. The issues of today are indeed pressing. But so were yesterday's issues, as will the issues of tomorrow. There is no way to quantify the relative importance of charity across generations — yesterday, today and tomorrow. Making this an issue of intergenerational justice is unlikely to prove helpful to reforming the disbursement quota calculation. That topic is much broader — with different considerations — than the question of what the disbursement quota should be.
- **how a foundation should invest its assets**. There are certain limits in the Income Tax Act (ITA) on how a foundation can invest its assets but, in general, they may invest in any publicly traded security and certain other types of investments. Some people have proposed that foundations should only allow investments in so-called mission-related

[5] Arguably, the federal government could remove a foundation's charitable status and tax exemption after a certain number of years, but that would introduce a host of new and different issues. Legislation to do that has been introduced in the United States Senate, but has not yet progressed.

investments, or ethical investments, or impact investments, or social enterprises, or program-related investments. Again, it is not clear that the federal government has the constitutional authority to establish such requirements. Even if it does, there is insufficient research to indicate what impact such limitations might have, even if there were common definitions of each type of proposed investments.

- **who a foundation can give money to**. The ITA says a foundation's resources can be used to make gifts to charities and other qualified donees, [6] and to carry out charitable activities directly undertaken by the foundation. Some people propose that foundations be able to gift funds to any organization spending money to further a charitable purpose. [7] This ability would extend to organizations which are not registered charities and wouldn't be subject to the reporting and oversight requirements applicable to charities. If a foundation can give money to any organization, it could result in less money going to registered charities. Other people believe (and the Budget statement seems to suggest) that an increase in the disbursement quota will automatically lead to greater support of so-called frontline charities. Again, that is not a safe assumption. Even if an increased disbursement quota leads to increased grants to charities, that funding could end up, disproportionately, going to institutional charities such as universities, hospitals, or museums. It could lead to foundations undertaking more programs directly. It could also be made, in certain cases, to support programs and organizations outside Canada.

Each topic might well represent an important discussion that needs to be had. However, until there is sufficient information to allow for broad-based discussions, trying to include these topics in a consideration of an increase in the amount of the DQ will only make consideration of an appropriate disbursement quota more difficult.

6. Things we Haven't Talked About

Changes have implications, and analyzing those potential implications before a change is made is critically important. With the disbursement quota, (and setting aside in this context calls for other unrelated changes some people encourage), there are at least three issues large enough they demand consideration.

1. **Investment practices foundations might have to adopt to meet an increased disbursement quota.**

   This is a provincial law concern, as foundations must comply with the prudent-investor rule. This rule, at its essence, says that charitable assets need to be invested as prudent investors would invest their own money. In investments, higher returns generally require an investor to take greater risks. [8] Changes to the disbursement quota could lead to

[6] Qualified donees include all registered charities, the federal, provincial/territorial and municipal governments, certain bodies (particularly First Nations) that carry out responsibilities similar to a municipal body, the United Nations and its agencies, certain universities outside Canada, registered Canadian amateur athletic organizations, registered national arts service organizations, and certain registered journalism organizations.

[7] Under the ITA, this includes making grants.

[8] In addition, raising the disbursement quota could cause charities (particularly those with trust law restrictions on their ability to encroach upon capital) to favour income-producing investments over capital appreciation. This could result in tax-driven investment strategies achieving sub-optimal investment results for the sector at large. If investment strategies sacrifice capital appreciation for greater income yields, there could be a tipping point in the future, at which payout under an enhanced

questions as to whether foundations were complying with the requirement to operate as prudent investors.

2. **Some foundations — mainly public, but also some private — are established under rules allowing them to spend only endowment income. They cannot encroach on capital.**

   A subset of these foundations may have established, by trust deed or contract, a requirement that expenditures be limited to some specified percentage. In these cases (and we do not know how many there are), there would be legal barriers associated with meeting any increased disbursement quota. It might be possible to obtain relief from these restrictions, but usually that involves an application to a provincial superior court. The time and cost associated with these applications, along with the workload on the courts, are factors that need to be considered before implementing any policy change. [9]

3. **The current regime allows for a foundation that houses donor-advised funds to meet the disbursement quota while still allowing some of those funds to continue to accumulate assets.**

   The third concern is not discussed in the budget announcement, and relates to applying the disbursement quota on donor-advised funds. That is because the disbursement quota is applied to the foundation and not to individual donor-advised funds. This has been receiving increased attention in Canada and the U.S. over the last decade, with calls to apply the disbursement quota at the individual-fund level. This would require significant changes to the reporting regime for those foundations that house donor-advised funds. We have insufficient data about the number or value of donor-advised funds to allow for an informed discussion on that question. A strong argument can be made that if the policy goal is to avoid having funds, which have resulted in tax benefits, "languish", the disbursement quota should be applied to those individual funds. This is another area where the government does not have (or has not released) enough information to allow for a reasoned debate.

   This issue arose before the Senate Special Committee on the Charitable Sector. In its report, the Committee addressed it by recommending a study to ensure "that donations do not languish in donor-advised funds, but are instead used to fund charitable activities in a timely fashion." [10]

disbursement quota will be less than would have otherwise occurred if the status quo were maintained (i.e.,a lower disbursement quota applied against an appreciating capital base). The behavioural effects of an enhanced disbursement quota on investment decision-making need to be considered very carefully.

[9] Tax incentives for charitable giving should be considered alongside and complementary to the various ways in which charity is enabled, promoted and incentivized under the "general law". Perpetual charitable purpose trusts with no encroachments on capital have long represented one way the general law makes charitable giving attractive. Tax rules should work in harmony with the general rule, especially as the tax treatment of "charity" is almost entirely based on principles drawn from the general law.

[10] Catalyst for Change, https://sencanada.ca/en/info-page/parl-42-1/cssb-catalyst-for-change/, last accessed June 19, 2021.

7. Conclusions & Recommendations

Periodic discussion of the disbursement quota is healthy. Investment trends and practices change. But, that discussion needs to be informed by publicly available information. It also has been historically strongly influenced by market changes rather than tax policy concerns.

Further, we listed several issues that people want considered in the consultations. Each issue may be important, but they require further information and greater consideration of the implications. They do not relate to the disbursement quota, but are seeking to change other non-DQ aspects of charity law — something that requires a different type of conversation. [11]

Before any proposed change to the disbursement quota is enacted, there needs to be clarity about the implications of that change and the possible adverse consequences need to be reviewed.

The Pemsel Case Foundation recommends:

1. **That the 2021 federal budget consultation be limited as much as possible to the disbursement quota rate**. Since current data is insufficient to make a sound policy determination about any additional tools, the consultation should focus primarily on the disbursement quota rate. A conclusion on additional tools is impossible without reliable data. If other changes to charity law are to be considered, such as a change in the rules related to perpetuities, qualified donees, investment limitations or the like, they should be separate consultations, part of a more general review of the law related to charities and, where appropriate, involve officials from the provincial and territorial governments.

2. **That no change to the disbursement quota be made without better data.** Some of the missing data may be in the hands of the Charities Directorate of the Canada Revenue Agency. This would include information about applying disbursement excesses and permissions for relief from the disbursement quota. Aggregate data should be made publicly available and support a conversation among affected governments and organizations. Before assessing the advisability of any additional tools or sanctions, it would be helpful to better understand the perceived gaps that exist within the existing compliance regime.

3. **That an examination should be made of how and the degree to which existing tools are used, and how CRA could gather the data necessary to successfully use existing compliance mechanisms.** Adding additional tools or penalties without any more enforcement than apparently now exists would not be productive.

4. **That the Charities Directorate undertake educational and compliance measures to ensure better data**. This includes ensuring that T3010 data is complete and accurate. As part of this initiative, the Canada Revenue Agency should restore the capacity within the online CHAMP system to ensure that a return is complete and that totals accurately reflect the components of calculations.

5. **Information be obtained and consideration given to whether the disbursement quota should be applied to existing individual donor-advised funds within a charity.** How new rules would apply in community foundations, hospital foundations and universities — all charities with many types of donor fund accounts — needs review.

[11] Charity law in Canada is developed at the federal level, primarily under the ITA; and by the provinces in a number of areas: wills and estates and investment rules, to note two significant ones.

6. **If government does increase the DQ rate for whatever reason, publicly available plans should be provided to later assess the impact of a change.**

Appendix A

Responses to Finance Canada Questions

Should the disbursement quota be raised to produce additional funding for charities, and to what extent?

No change should be made, at this time, but should await data that allow proper analysis of the current situation, including the question of which foundations are currently not meeting the disbursement quota, and the impact on investment practices and trust agreements that could be required with an increased disbursement quota. Any amendment of measures related to the disbursement quota should be grounded in a well-articulated policy rationale. Their efficacy should be assessed transparently and based on publicly available data and criteria.

A change in the disbursement quota should not be used to replace government funding either generally or in respect of COVID-19.

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

The disbursement quota should take into account reasonable assumptions about financial returns of foundations, including the level at which Government of Canada bonds are issued. The analysis requires recognition of the responsibility of foundation trustees to observe prudent-investor rules and other legal obligations beyond the scope of the ITA. Federal policy decisions may give rise to legal implications at the provincial level. Beyond prudent investor requirements, charities may be, for example, prevented from encroaching on the capital by the specific provisions under which a charitable trust was settled. If the quota requires a charity to encroach on the capital of a trust, the charity may have to apply to a court to resolve the problem, thereby incurring additional delays and costs. Encroachment is generally undesirable because it can distort investment decisions. Where it is a consequence of the DQ rate, it can potentially trigger additional administrative costs and place charities in conflict with provincial law. Data on investment returns and other economic factors should be available to support the chosen rate.

What additional tools (e.g., monetary penalties or other intermediate sanctions) should be available to the CRA to enforce the disbursement quota rules?

No additional penalties should be introduced until such time as CRA has better means to ensure accurate filing of information returns, has time to make the DQ more of a focus of audit activity and enforce the existing disbursement quota rules. We do not understand that this is a current audit focus. Should that change without a response by registered charities, then there may be a need for an intermediate sanction related specifically to the DQ.

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

Yes. They exempt charities from being subject to a disbursement quota in justifiable circumstances.

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. While the carry-back provision raises compliance issues around fraudulent charities, there is no evidence that problems exist because of the carry-forward provisions, as long as the starting data on the possibility of a carry-forward can be reliably ascertained.

Are there any temporary changes to the disbursement quota that should be considered in the context of the COVID-19 recovery?

No. The disbursement quota has not, historically, been used as a tool to address broader economic conditions. As well, there is anecdotal evidence that several wealthier foundations did increase their giving in past times of need. Temporary or permanent change in the policy rationale for the disbursement quota should be clearly and publicly stated, well in advance of being implemented. Once a new or additional rationale is in place, any changes made should be assessed transparently using reliable public data and criteria.

The Pemsel Case
FOUNDATION

Suite 1150, 10060 Jasper Avenue,
Edmonton, Alberta, T5J 3R8

www.pemselfoundation.org