Disbursement Quota Research - Occasional Paper

The Disbursement Quota Revisited

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ISBN:

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

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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.

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The Disbursement Quota Revisited

1. Introduction

The Canada Revenue Agency, through the provisions of the *Income Tax Act*, is the de facto regulator of charities in Canada. Charities registered under the Act must spend a minimum amount of funds on their charitable programs and/or gifts to "qualified donees".[1] This minimum amount is calculated using a formula found in the Act, known as the "disbursement quota". The quota's objective is to ensure that charitable donations are being invested into communities, and helping people in need.

On April 19, 2021, the Government's Budget proposed launching public consultations with charities over the coming months on potentially increasing the disbursement quota rate and updating the tools at the Canada Revenue Agency's disposal, beginning in 2022. The Budget document argues that changes to the quota could potentially increase support for the charitable sector and those that rely on its services by between $1 billion and $2 billion annually.

2. Why this matters

The disbursement quota is not new, and it has had a chequered past. The Budget documents mention not only increasing quota percentages, but obliquely refer to "tools" to enhance the quota's operation. **If anything, the charitable sector in general should be concerned about government initiatives to reform the quota, as well as claims about its potential benefits**.

There are reports that the Department of Finance aims to have a recommendation on the disbursement quota ready for the fall of this year, should the Government want to make an announcement on substance in this fall's economic statement or in the 2022 Budget. It is likely that the Government will want to consult with the charitable sector, and with that in mind, surely what is needed is a thoughtful policy conversation that takes into account the capacities, the needs and the constraints of the sector.[2]

[1] See, as appendix to this document, Finance Canada, *Budget 2021*, Part II, chapter 6, section 6.3 https://www.budget.gc.ca/2021/report-rapport/toc-tdm-en.html "Qualified donees" are organizations, including other registered charities, that can issue donation tax receipts in their own right. They include Canadian municipalities, the United Nations and its agencies, and registered journalism organizations. See the definition in the *Income Tax Act,* subsection 149.1(1).

[2] See also: https://www.investmentexecutive.com/newspaper_/news-newspaper/feds-eye-increasing-charities-disbursement-quotas/

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3. What is the disbursement quota?

The disbursement quota requires registered charities to spend a portion of their revenues and assets on their own "charitable activities" and/or gifts to "qualified donees". A segment of the charitable sector has been subject to a quota of sorts since at least 1948.[3] But what concerns the sector today are the measures that were put into place in 1976,[4] and in successive years, some of which are still in place.

4. A retrospective of the former disbursement quota

The Ontario Law Reform Commission summarized its view of the 1976-77 disbursement quota legislation by adding that the rules regulating charities in the *Income Tax Act* were "…written into the Act in accordance with the worst traditions of draughtsmanship that Canadians have come to expect from the *Income Tax Act*."[5]

Generally speaking, in the mid-nineteen-seventies, the tax rules for registered charities were substantially revised. Three classes of charities were created: charitable organizations – the 'do-ers' of charitable work—and the 'funders', in other words, public, and private foundations.

(a) The Eighty-Percent Rule

The lynchpin of the original disbursement quota, as intended for charitable organizations as well as public foundations, was a requirement to spend 80% of tax-receipted donations on the organization's "charitable activities" and/or gifts to "qualified donees" in the following year. It was originally intended to control fund-raising costs, and to a lesser extent, self-dealing by charity administrators and non-arm's length people.[6]

However, the quota's focus on "charitable activities" contained interpretational challenges from the start. Because basic concepts were not defined in the legislation, the quota made it inherently difficult to characterize, track and report expenses. The Act was (and still is) silent on the notion of "charitable activities" in particular, and one person's perception of charitable activities could vary from another's, or indeed from that of the Canada Revenue Agency, based on one's own interpretation of the sequencing of steps that eventually achieved a program-delivery objective. The silence of the Act on definitional issues, the overlapping of key concepts and the resulting subjectivity often led to inadvertent errors in reporting, or to attributions that were deliberately

[3] Prior to 1976-77, there was already a quota of this type on the income of charitable non-profit corporations and charitable trusts (as they then were). See *Income Tax Act,* 1970-71-72 S.C., c. 63, subsections 149(1)(g) and (h); also 1952, R.S.C., c. 148, subsections 62(1)(e), (f), and (g).

[4] Effective January 1, 1977.

[5] *Report on the Law of Charities,* 1996, volume 1, p. 277.

[6] The 1976 amendments also required public and private foundations to spend 90% of their annual income or 5% of their capital, in a prescribed manner. Department of Finance, *Budget Paper 'D',* "Charities Under the *Income Tax Act*", May 25, 1976, p. 6. See a further explanation below.

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manipulated to meet quota requirements. This made the quota a trailing indicator of compliance rather than a leading one, and made it an unreliable predictor of trouble or mischief in a charity.

From the onset as well as in subsequent years, it became obvious that the 80% rule was insufficient, if not inadequate. Supplementary rules were added either at its inception in 1976, or in following years, to adapt the quota formula to the realities and complexity of the sector. However, these also brought additional challenges in getting charities to comply with, and report on the quota. These add-ons included, for instance,

- measures to account for the start-up costs of incipient charities;
- carry-forwards and carry-backs to cover overspending in a given year, or lack of income in another year (as a result of unsuccessful fund-raising drives, for instance);
- exemptions from the quota to allow a charity to accumulate funds for large-scale capital projects, as well as calculations to prevent distortion to quota-based expenditures when accumulated funds were eventually spent;
- exemptions for bequests, endowments, and "ten-year gifts", as well as corresponding rules to bring amounts back into, and modify the amount of the quota, if they were spent ("enduring property");
- measures formerly applicable to foundations, but eventually applied to charitable organizations, to prevent the continued 'parking' of investment funds that should instead be actively applied to charitable relief;
- a "capital gains pool" to allow charities to encroach on the appreciated value of its "enduring property" in order to meet quota requirements;[7]
- "designated gifts", to enable transfers between charities that weren't operating at arm's length with each other; and
- measures to factor in gifts from other registered charities, not including certain gifts of capital from one charity to another ("specified gifts" and "multi-year transfers").

These layers produced an unnecessarily complex web that was "…difficult, if not impossible, for the average charity to understand, let alone comply with."[8] Accordingly, non-compliance levels were, and if the comments in the companion piece on data are any guidance, they remain substantial. In spite of this, it would seem that no single charity was ever revoked solely for failing to meet its disbursement quota.

It should be noted that some of these same issues may crop up with proposed approaches to a revised disbursement quota.

[7] See for instance: https://www.canada.ca/en/revenue-agency/services/charities-giving/charities/policies-guidance/treatment-enduring-property-purposes-disbursement-quota.html

[8] E. Hoffstein and T. Man, *New Disbursement Quota Rules Under Bill C-33,* Paper presented to the Canadian Bar Association National Symposium on Charity Law, Toronto, April 14, 2004, at p. 30.

The wide variation in income and expenditure characteristics across the charitable sector meshed poorly with the quota's more-or-less fixed formula. It was not sensitive to an individual charity's circumstances, whether a charity was incipient or well-established, large or small, popular or highly specialized, entirely reliant on donations or on other income, or whether it was operated by volunteers or paid staff. As a result, the quota had an uneven and inequitable effect on individual charities.

In fact, the quota did not regulate charities' fund-raising costs or administrative expenditures, notably because it captured only receipted donations, but not *un*receipted donations or indeed, income from other sources such as revenues from related business activity or government funding. Instead, the quota may even have fostered fund-raising abuse. Indeed, because of its carry-backs and carry-forwards, it made it impossible for the Canada Revenue Agency to identify non-compliance via audit until three or more years later. As well, it implicitly expected a charity to internally segregate and limit cost allocations from other income streams when interchangeability is often unavoidable and where concepts such as fund-raising, charitable activities, administrative costs, and related business overlap each other.

From a pure compliance and monitoring perspective, the quota made it impossible to distinguish between—on the one hand—fund-raising and administrative costs that can vary widely and naturally according to circumstances, and on the other, deceptive practices in which fund-raising and administrative costs are deliberately misstated or distorted.

Moreover, it provided a false impression to an uninformed public and to the media on the relative performance of any given charity because its basic formula, though widely popularized, did not take into account a number of revenue streams and cost constraints.[9] Accordingly, it also had little value as a general tool to compare one charity's efficiency to another.

Ultimately, the quota was unworkable because it tried to address too many issues at once:

- providing a tax environment in which charities could thrive and make their valued and essential contribution to the health and well-being of our Canadian society;[10]
- compelling charities to apply their funds to program delivery rather than simply accumulating them; [11]
- ensuring continued eligibility for charitable registration, and enforcing the "exclusively charitable" standard; [12]
- encouraging efficiency by limiting fund-raising and overhead costs; [13]

[9] For instance, grants, fees-for-services, profits from related business, corporate sponsorships…

[10] Department of Finance Discussion Paper, *Charities and the Canadian Tax System,* May 1983.

[11] Department of Finance, *Budget Paper 'D", op. cit.;* Department of Finance Discussion Paper, May 1983 op. cit.; Panel on Accountability and Governance in the Voluntary Sector, *Building on Strength, Improving Governance and Accountability in Canada's Voluntary Sector,* Final Report, February 1999, p. 67.

[12] Ontario Law Reform Commission, *op. cit.* p. 304.

[13] Department of Finance, *Budget Paper 'D', op. cit.*

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- monitoring receipted income and tracking the cost of the charitable tax privileges to government; [14]
- preventing undue private benefit;[15] and
- increasing public and donor confidence. [16]

This conflation of multiple and sometimes tenuous purposes compromised any assumed policy objectives.

After substantial lobbying by the charitable sector during the years leading up to 2010, the 80-percent portion of the quota was eliminated.

(b) The 3.5 Percent Rule

Currently, the only remaining portion of the disbursement quota formula requires a registered charity to spend 3.5% of the value of any assets that were not used directly in charitable activities or administration.[17] Presumably, this refers primarily to investment assets, although, for example, it may also cover land and buildings, savings accounts, inventory, artwork, as well as stocks, bonds, mutual funds, and GICs.[18]

For charitable organizations, the quota is nil if the value of the assets in question averaged over the past 24 months is $100,000 or less. For public and private foundations, that exemption limit is set at $25,000 or less.

Much of the above discussion on the eighty-percent rule has omitted any problems relating specifically to the 3.5% portion of the quota. However, many of the above criticisms still apply. Notably, the quota still revolves around the notion of "charitable activities carried on by it".

It should be noted that the percentage for this portion of the disbursement quota was originally 4.5%, but it was reduced in 2004 to 3.5% in order to allow charities to maintain a capital asset

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[14] Ibid., See also, Department of Finance Discussion Paper, *Charities and the Canadian Tax System, op. cit*.

[15] Department of Finance, *Budget Paper 'D', op. cit.* also, Department of Finance, Discussion Paper, *The Tax Treatment of Charities,* June 1975.

[16] Department of Finance, Discussion Paper, *op. cit.*

[17] *Income Tax Act,* subsection 149.1(1), "disbursement quota".

[18] If a building is used partly for charitable activities and partly for other reasons, the non-charitable portion needs to be pro-rated and included in the calculation. On the other hand, property accumulated under a permission granted by the Minister does not need to be included in the value of assets. The average value of property is based on a specified number of periods (decided by the charity) over a 24-month span. The 24-month span can be divided into two to eight equal, consecutive periods. The number of periods is usually chosen when the charity files its first information return. Once chosen, the charity must get the Canada Revenue Agency's written permission to change it. For instance, if a charity calculates the value of its property only once a year, it will use two 12-month periods to calculate an average value. If it values its property every six months, then it will use four six-month periods to calculate an average value. To establish the average value, the value of the charity's property that is not used directly in charitable activities or administration must be determined at the end of each period within the 24-months. The values are then added together and the resulting total is divided by the number of periods. The result is the charity's average value of property for the purpose of calculating the disbursement quota. https://www.canada.ca/en/revenue-agency/services/charities-giving/charities/operating-a-registered-charity/annual-spending-requirement-disbursement-quota/disbursement-quota-calculation.html

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base on a sustainable, long-term basis.[19] The 2004 document went on to state that the 3.5% rate would be reviewed periodically to ensure that it continues to be representative of long-term rates of return. **From the 2021 Budget documents, it is likely that this percentage will be central in the consultations that are to take place.**

One finds an equivalent quota on investment and other assets, in many other countries. There is a logical argument supporting some kind of control over the need to ensure that a charity's "other assets" are eventually applied to actively pursue the purposes for which a charity was registered. This kind of quota is easier to implement because non-program assets are usually held in the form of investments, and the incomes are easily circumscribed. In addition, charities which have substantial investment holdings are usually granting organizations—which circumvents the need to characterize their expenditures as "charitable" or not. On a conceptual level, this tends to make it easier as these charities typically—but not always—fund other charities. Moreover, granting organizations usually receive and hold large gifts, and if these are exempt from any other kind of disbursement quota, a regulator is at least drawn to establish a separate quota on investments to prevent these assets from lying dormant, and ensure that at least a portion of their value is applied toward charitable programs.

However, there are substantial concerns in applying such a quota to front-line charities. As a result of their operational commitments, these charitable organizations need greater latitude in planning for future contingencies, and therefore more flexibility in the rate at which they can set money aside. Front-line charities tend to hold different non-charitable assets than granting charities. Typically, charitable organizations also have leaner budgets. These considerations might argue for a lower percentage rate or some other threshold for charities that are in the trenches, as opposed to granting organizations.

Any review of the quota also needs to bear in mind the distorting effect on aggregate data created by the fewer but far wealthier charities – for instance, wealthier private foundations, universities, hospital foundations and large religious organizations – whose considerable reserves tend to set them apart from the vast majority of other, average charities.

The current wording of this portion of the quota refers to "property not used directly in charitable activities and administration". This raises a number of interpretational issues, notably the treatment of:

- the subjective and persistent concept of charitable activities, and the operations and assets connected to it;
- the valuation of real estate, notably property that is only used by a charity occasionally or during part of the year;
- artwork and other assets such as tracts of land, that aren't susceptible to fragmentation in order to meet the quota; and

[19] Finance Canada*, Budget Plan 2004*, annex 9, page 361.

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- term deposits of a few months, as well as endowments acquired subject to restricted purposes.

An additional reason why charities argued for a lower percentage rate in 2004 was the need for a more solid investment base. It is difficult for charities to maintain ongoing multi-year programs or indeed plan for future programs without knowing whether annual funds will come from granting organizations and governments. This requires them to be in a position to use their own investment earnings as a cushion while still maintaining their asset base.

An increase in the quota percentage may not mean 'more money'. It may be that the *Income Tax Act* has already created a new definition of charity—one that accepts the common law concept as a base, but that expands it through legislative fiat, by adding an increasing number of "qualified donees". The addition of some new qualified donees may mean that the amount of grant monies currently available to existing sector organizations remains flat, with an increasing portion going to these new arrivals. It should be noted in passing that most qualified donees don't have a disbursement quota. Forcing foundations to spend greater amounts may not mean that these will necessarily go to front-line charities that are cash-starved. It may instead manifest itself not only as gifts to incipient classes of qualified donees, but also as greater gifts to galleries, museums, and hospital and university foundations.

An increase in the quota percentage may require charities to reconfigure their investment portfolio toward more liquidity—an operation which may take several years depending on the portfolio. Incentivizing riskier investments may force charities to contravene provincial trust law requirements that they invest monies prudently, typically in portfolios whose rates of return tend to be safe but conservative in their earnings. Many charities currently harbor endowments that have significant restrictions on capital encroachment either within the deed creating the endowment or as a result of trust law. Under the terms of trust law, income consists only in interest and dividends – not the appreciated value of the capital base. Encroachment on capital would amount to a breach of trust, and applications to the courts to vary the terms of a trust would complicate matters even more and amount to substantial additional costs to the charity.

An increase in percentage may affect foundations more than charitable organizations. While the Budget appeared to be mainly concerned with a spending gap in public and private foundations, there has also been some talk about collapsing public foundations and charitable organizations into a single category of "public charities". If so, a quota intent on getting all foundations to disburse more funds may adversely affect charitable organizations as well.

A revised quota may inordinately affect the program delivery of very wealthy charities. It may also adversely affect smaller foundations that are possibly below the current quota or barely meeting it, not necessarily because of mismanagement but because of asset profile or extraneous reasons.

A review of the quota also raises several side issues. Notably, some organizations, not all "private foundations", should be open to greater CRA scrutiny.

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- Closely held charities where there is little or no community scrutiny because membership is restricted essentially to a permanent board of three or so directors, some of them purely nominal, need to be monitored more closely because there is little or no public scrutiny, and consequently more opportunity for mischief.
- Donor-advised funds appear to be problematic. They may meet a quota in the aggregate, in the host organization seen as a whole, but individual funds may be held for longer periods without being applied to program relief. DAFs apply funds at the donor's discretion, but in complete secrecy. An individual donor's discretionary view of what is "charitable" doesn't always mesh well with the legal definition, and the concealment of funds within a host organization prevents any in-depth supervision by the Canada Revenue Agency. Often the main beneficiary of the fund, arguably, is the investment company that manages the fund.

If changes are in the offing, the underlying policy intent of any measure and indeed any quota, should be clearly and consistently articulated. Sources of subjective interpretation in the Act need to be addressed. Any changes should be backed by some form of actuarial analysis to fully understand the need for change, as well as the impact of any change on the asset base. Compliance needs to be monitored and enforced. And based on past experience, charities and policy-makers need to keep in mind that a rule can be absolutely simple in its conception but procrustean in its application, or it can adapt itself to the complexity of the charitable sector, but become substantially unmanageable from a compliance perspective.

A Pemsel data analysis, focusing on available T3010 data, suggests that there are significant issues around data collection and enforcement. These should be addressed before, or in tandem with legislative changes, to ensure that policy initiatives and the ensuing consultations are evidence driven.

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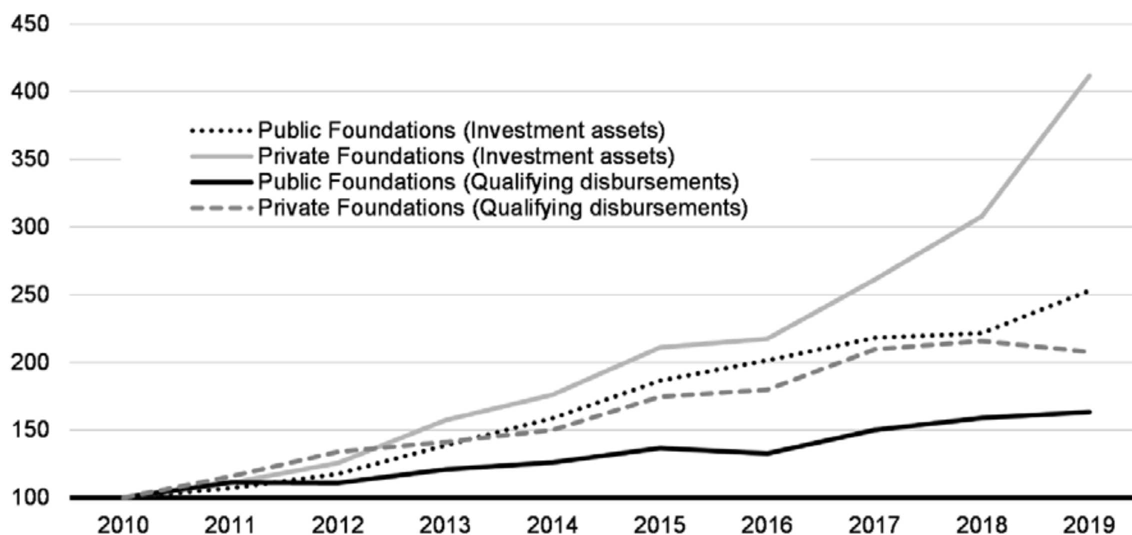
Appendix

Excerpt from Budget 2021 document, Part 2, chapter 6

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.

Chart 6.2
Growth in Investment Assets and Qualifying Disbursements
Index, 2010 = 100



*Source: Canada Revenue Agency T3010 data SEQ Source:_Canada_Revenue_Agency_T3010_data **

Text version

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.

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