

# New Tax Proposals for Charities

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On May 17th, 1983, the Department of Finance of the Government of Canada issued a discussion paper containing draft legislation proposing broad changes in the tax treatment of both charitable foundations and charitable organizations. While the proposals reflect the agreement reached in April 1982 with the Association of Canadian Foundations with respect to the charitable foundations, the proposals will also now alter the disbursement rules for charitable organizations in Canada. Several new concepts are also being introduced, one of which will eliminate the legislative distinction between a charitable foundation and a charitable organization.

Among the significant new concepts being introduced are the following:

1. The distinction between charitable foundations and charitable organizations would be eliminated.

Under the existing legislation, charities are classed as either charitable organizations or charitable foundations with foundations being further subdivided into public foundations and private foundations. These classifications would disappear and all charitable entities would simply be referred to as charities with the same tax rules applying to all.

2. Related charities.

The term "related charities" is new to the *Income Tax Act* and will apply to those charitable entities having major donors in common or those instances where one charity was created or established to further the purpose of the other or where one charity did not deal at arm's length with the other. Hospitals and their respective hospital foundations would fall into the definition of "related charity". Organizations in this new category would be subject to proposed disbursement rules which would require that an amount equivalent to 100 per cent of the value of a gift to a charity from a related charity be spent in the year of receipt. Also, when a disbursement quota for a year is established, gifts between related charities will be netted.

3. The calculation of minimum disbursement requirements will be significantly altered.

For foundations, the 90 per cent-of-income distribution rule will be eliminated and will be replaced by a minimum disbursement quota equal to 4.5 per cent of the investment assets of the foundation. Additionally, for those foundations receiving donations, a further disbursement will be required of 80 per cent of all gifts (with certain exceptions). The distribution rules for an operating charity will be 80 per cent of all gifts received in the prior year (with certain exceptions) and an amount equal to 4.5 per cent of the market

value of investment assets, as determined, where the amount on which the percentage is applicable is greater than \$250,000.

The significant change here for the charitable organizations is the application of the 80 per cent test to *all* gifts rather than received donations and the introduction of the 4.5 per cent test on investment assets.

#### 4. Penalty taxes on disbursement deficiencies.

Where a charity has not met its disbursement quota a tax of 15 per cent of the deficiency will be imposed and if the deficiency is not made up after formal notification a further tax of 100 per cent of the deficiency will be imposed.

#### 5. Non-qualified investments.

The existing concept of “qualified investments” will be eliminated and replaced with the concept of non-qualified investments, applicable to *all* charities.

Non-qualified investments will include non-arm’s-length investments by a charity where there is a potential for self-dealing between the charity and related persons.

#### 6. Penalty to be applied to person who benefits from a non-qualified investment of a charity.

Where a non-qualified investment of a charity does not earn the minimum rate of return provided under the tax rules, the person benefitting by the lesser return will be required to include in income *twice* the amount the actual return is short of the required return.

### **Charities and the Canadian Tax System**

This 46-page document, copies of which are available from the Tax Policy and Legislation Branch, Department of Finance, 160 Elgin Street, Ottawa, Ontario, K1A 0G5, bears close study by all registered charities.

#### **Summary**

The following summary of the new federal tax proposals for charities was prepared for a series of cross-country seminars on their *Impact and Effect* developed by The Canadian Centre for Philanthropy in co-operation with the Federation of Junior Leagues of Canada and The Canadian Bar Association.

1. The legislative distinction between a charitable foundation and a charitable organization will be eliminated and the definition of a charity is consolidated and expanded to include both foundations and charitable organizations.
2. A defined term, “major donor”, is to be introduced and will be of particular significance in determining whether charities are “related”.
3. The existing definition of “qualified investment”, which applied only to private foundations, is to be replaced by a definition of “non-qualified investment” which will apply to *all* charities. Non-qualified investments generally will be limited to self-dealing or non-arm’s-length transactions such as loans and equity investments.

4. The concept of “related charity” is introduced and is of significance with respect to the disbursement requirements in connection with gifts from one related charity to another. An amount equal to the value of such gifts, with some exceptions, must be expended in full by the recipient charity in the year of receipt.
5. The provision permitting accumulation of property for a particular purpose (with written approval of the minister) is to be continued but income earned on the property accumulated will not automatically be included in the accumulation. Approval to accumulate the income would also need to be obtained.

The existing rule which stipulated that accumulated property not used for the purpose for which it was accumulated was deemed to be “income” of the charity, is to be changed. Such accumulated property will now be deemed to be a gift from a related charity. Thus an amount equal to 100 per cent of the value of the property must be disbursed and the disbursement must take place in the second year following the year the charity decided not to use the property for the purpose for which it was accumulated.

6. Existing rules which set out the circumstances in which a foundation is deemed to control a corporation are to be modified and will now apply to all charities. Acquisition of control of a corporation could result in the deregistration of a charity.
7. The time within which public information returns must be filed is to be extended to four months, rather than the present three months. A corporate charity will no longer be required to file an income tax return.
8. Non-qualified investments of a charity will be required to earn a minimum annual rate of return. Where the investment does not earn the stated minimum return, the taxpayer who received the loan or the corporation whose shares are held by the charity will be required to include in its income twice the difference between the interest or dividend actually earned and the minimum rate of return which was required to be earned.
9. Under the existing rules, when a charity failed to meet its disbursement requirement for a year (subject to the five-year averaging rule) the minister could deregister it. Under the proposed rules, an initial penalty tax of 15 per cent of the deficiency in the disbursement will be assessed and if the deficiency is not made up within a 90-day period after notice of assessment, a second tax of 100 per cent of the deficiency will be assessed.
10. The disbursement rules for both foundations and charitable organizations are to be changed significantly. Under the proposed rules both charitable foundations and charitable organizations will be required to expend on “qualified disbursements” an amount at least equal to the disbursement quota. In a mature system a charity will be required to disburse annually an amount equal to the aggregate of the following:
  - (a) 100 per cent of gifts received in the year from related charities (with the exception of gifts received out of capital and gifts of property which are used in charitable activities or administration);

- (b) 80 per cent of *all gifts* received in the immediate preceding year, except gifts from related charities, gifts out of capital and certain other gifts;

A gift, except a gift from a charity, that is subject to a direction that it be held for a period of not less than 10 years will be excluded from the disbursement quota;

All testamentary gifts, except those with direction to use within 10 years, will be excluded from the disbursement quota;

Where a gift received from other than a charity is subject to a direction that it be used within a 10-year period, only 80 per cent of a pro-rata portion of the value of the gift must be included in the disbursement quota;

- (c) 100 per cent of the amount of loans received and repayments received on loans made for charitable purposes. In general, an operating charity will be exempt from the 4.5 per cent disbursement requirement if the investment assets of the charity (as determined in the *Income Tax Act* and on which the percentage is calculated) are less than \$250,000;
- (d) 4.5 per cent of the amount by which the “value of the charity’s investments at the beginning of the year” exceeds item (b).

11. A transitional rule is to be provided for foundations which claimed an income reserve in the last year of the existing rules.
12. Amounts disbursed by a charity above the minimum disbursement quota are to be deemed unused excess qualified disbursements and may be used by a charity to cover a deficiency in the disbursement quota in any of the five years following the year in which the excess arose.
13. The income tax regulations will be amended to set out the methods of valuation of the investment assets for purposes of determining the fair market value on which the 4.5 per cent disbursement quota will be applied. For disbursement purposes, the “value of assets at the beginning of the year” will be the average value of the assets held over the two prior years. The valuation may take place at intervals ranging from simply the two prior year ends to a valuation at the end of each quarter year during the 24-month period. All charities, including a new charity, will be treated as having existed at the end of each chosen period in the preceding 24-month period. Once a charity has chosen the number of valuation periods, the same number of periods will be required to be used in subsequent years unless approval has been given for the use of a different number of periods.

Marketable securities will be valued at fair market value, whereas shares in a private corporation or an interest in real property will be valued by an independent appraisal at least every three years.

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**Submission by the Board of Directors, The Canadian Centre for Philanthropy to the Department of Finance, Government of Canada, August 1983.**

*(When the new federal tax proposals for charities were made public on May 17, 1983 the Minister of Finance, Marc Lalonde, indicated that the government would welcome a response by interested parties. The following is a brief summary of the response of The Canadian Centre for Philanthropy. The entire 48-page Response may be purchased in English or French from the Centre. For information about how to order and the cost per copy please phone (416) 364-4609 or write to Tax Response, The Canadian Centre for Philanthropy, 185 Bay Street, Suite 504, Toronto, Ontario M5J 1K6.)*

**Preface**

*The New Federal Tax Proposals for Charities: A Response from The Canadian Centre for Philanthropy* is a submission of the Board of Directors of the Centre to the Department of Finance, Government of Canada, prepared by the Centre's Legislative Watch Ad Hoc Committee.

The Legislative Watch Committee was established by the Centre following the Federal Budget of November 1981 to provide continuing review of government legislation affecting Canadian charities. The first results of the Committee's efforts were two publications: *The Federal Budget Resolutions of November 12, 1981 and Their Effect on Charities in Canada* and *Endowed Charitable Foundations in Canada: A Study of Spending and Investment Strategies Under Revenue Canada Regulations*. (See *Bookshelf* pp. 47-52.)

The Ad Hoc Committee of the Legislative Watch Committee was formed to deal specifically with the new proposals outlined in *Charities and the Canadian Tax System: A Discussion Paper*, made public by the Minister of Finance on May 17, 1983. The Centre's Chairman, Mr. Jack Barrow, has written directly to the Minister, Marc Lalonde, identifying our concerns and recommendations.

The Centre also responded to the new tax proposals by holding seven seminars in central locations across Canada, with the co-operation of 20 other charitable organizations. These seminars discussed the implications and ramifications of the proposed changes for charities' operations and management. Total attendance was just short of 1,000.

The reactions and concerns of those attending the seminars have been taken into consideration in the *Response* but we do not claim to speak for the various charitable sectors. We *do* strongly encourage charities to consider our *Response* and the information their representatives received if they attended the seminars when they are preparing their own submissions. (As noted at the head of this summary, the *Response* is available from the Centre in both English and French. It has already been made available to Associates of the Centre and those who attended the seminars.)

The Ad Hoc Committee was made up of representatives from major charities and legal and accounting firms who volunteered their time and expertise to analyze, evaluate and prepare a response for the Board of Directors of the Centre. We would like to extend our thanks to all those involved in this preparation.

The Canadian Centre for Philanthropy works to encourage philanthropy throughout Canada. Its success in achieving this aim is due to the financial support it receives from Associates and interested foundations and corporations and to the efforts of dedicated volunteers.

ALAN ARLETT  
Executive Director

### **Executive Summary**

The Canadian Centre for Philanthropy has carefully studied the comments and draft legislation contained in *Charities and the Canadian Tax System*, the discussion paper released by the Department of Finance on May 17, 1983.

While agreeing with the Department's stated goals and objectives, the Centre disagrees with many of the legislative provisions designed to attain them. What follows is a summary of the Centre's major areas of concern and its recommendations:

**Extreme Complexity** — The complexity of the proposals will lead to frustration and unnecessary expenditures of time and professional fees. If the proposals are not simplified, publication of an accompanying explanatory guide will be essential.

**Single Registration System** — In order to avoid unnecessary complexity, the distinctions among the three types of charitable entities should be maintained.

**Use of Property** — A charity should be permitted to make its property available to employees who are involved in its charitable activities or to members who are in need.

**Non-Received Gifts** — Gifts made to a charity for which the donor has not received an official tax receipt should not be included in the charity's income for the purposes of the disbursement quota.

**Definition of "Gift"** — The word "gift" should be defined, and should not include government grants.

**Penalty Tax** — The 15 per cent penalty imposed for failure to meet the disbursement quota should be refundable if the shortfall is made up, and joint and several liability for penalty taxes should be limited to situations of control.

**"Related Charities" and "Major Donors"** — The "related charity" concept is too broad and should be eliminated or limited to obvious situations of control.

**Disbursement Quota** — The Centre has identified several areas of specific concern, which are discussed separately in its submissions.

**Accumulation Rules** — Interest on accumulated funds should be added automatically to the fund and the purposes for which an accumulation will be permitted should be expanded.

**Qualified Disbursements** — Special relief to new charities with respect to the limitations on fundraising expenses should be made available to new charities.

**4.5 Per Cent Rule** — Since an investment portfolio would not be able, over the long term, to maintain the real value of its assets while meeting the 4.5 per cent disbursement requirement, the required rate of disbursement should be reduced to 3.5 per cent.

**Rate of Return on Non-Qualified Investments** — This area requires further study.

**\$250,000 Threshold** — More equitable treatment of charities would result if the first \$250,000 of investment assets of *all* charitable organizations were exempt and if the amount were indexed for inflation.

**Related Business** — Remuneration of those carrying on “unrelated” businesses should be permitted where the business has some identifiable relationship with the charity’s objects.

**Control of a Business Corporation** — Corporations set up by a charity to extend the benefits of its charitable activity should be permitted.

**Annual Filing Deadline** — The deadline should be increased to six months after the end of a charity’s fiscal year. This would be consistent with the deadline imposed on other corporate entities.

**Gifts to Non-Residents** — While disbursement of funds to overseas charitable activities should be permitted in certain circumstances, this area requires further study.

It is the opinion of the Centre’s Board of Directors that the Department of Finance’s response to the serious concerns raised by the charities should embody the following major recommendations:

1. The legislative distinction between private and public foundations and charitable organizations should be maintained.
2. Each charity should be designated as one of the three types of charities, and ministerial permission should be required for a change in designation.
3. The definition of “related charities” should be restricted to situations of control.
4. The exemption of non-receipted donations (including government grants) from the determination of the disbursement quota should be continued.
5. The proposed 15 per cent penalty taxes should be refundable.