What Is Income? What Is Capital?

JOHN HODGSON
Blake, Cassels & Graydon, Barristers and Solicitors, Toronto

What is income? What is capital? The distinction between the two has been likened to that between the fruit of the tree and the tree itself. It is a distinction which has troubled most people who have filed an income tax return. It is even a distinction of significance to registered charities in Canada, notwithstanding their exemption from income tax.

The distinction between "capital" and "income", however, is rather more elusive than the example of the tree and its fruits would indicate. If you are defining them for the purposes of the *Income Tax Act,* you may arrive at an answer which bears little or no relationship to the answer which the courts have arrived at for other purposes. Accountants have adopted generally accepted principles which may differ from both. If you are asked, therefore, to respond to the questions, "What is income and what is capital?", you may first have to ask, "Who wants to know?"

For most charities, most of the time, definitions of capital and income are of concern only if the distinctions have any significance in the protection of the registered status which provides the charities with exemption from income tax. The granting and revocation of that status are entirely dependent on compliance with the provisions of the *Income Tax Act* as administered by Revenue Canada.

Since retention of registration, once obtained under the *Income Tax Act,* depends on compliance with specified administrative tests, the *Income Tax Act* requires the charity to file an annual information return. This means its compliance with the *Income Tax Act* is subject to scrutiny every year and its continuing registration therefore at hazard.

The general propositions from which the *Income Tax Act* regulations have been developed are that:

(a) Resources received for charity are to be used for charitable activities;

(b) Current income from charitable sources is to be spent currently;

(c) Carrying on a business is not a charitable activity;

(d) Charities must make public disclosure of their activities.

Each is easily supported as a general proposition but open to criticism and disagreement in its specific applications. The legislative history reflects the continuing dispute between contending views.

For present purposes only (a) and (b) are considered: charitable resources are to be used for charitable activities and current income is to be spent currently. These have been enforced by the application of arithmetic rules-of-thumb which are to be calculated and set out in each charity's annual return of information to Revenue Canada.

In the period after January 1, 1977 and prior to January 1, 1984, the *Income Tax Act* gave effect to the first proposition by requiring that all charities disburse an amount equal to 80 per cent of the amount they had received as donations in the previous year and for which they had issued official receipts. (Receipts which donors could in turn use to claim a charitable deduction from their taxable incomes.)

It gave effect to the second proposition by requiring that those charities registered as "foundations" (in contrast to those registered as "charitable organizations") also disburse an amount equal to 90 per cent of their current year's income. Only the first test applied to charitable organizations, so they were untroubled by definitions of income for the purpose of the *Act.* The fact that they might incidentally hold substantial income-earning endowment funds was of no significance. The second test with which foundations had to comply had a very substantial loophole. It specifically excluded capital gains from the definition of "income".

Foundations, as a result, were faced with the necessity of making some very practical decisions, the importance of which was highlighted during recent years of high inflation. If they chose to put their funds in interest-earning investments so as to benefit from historically high interest rates, 90 per cent of the amount of the additional income was added to their disbursement requirement, notwithstanding the fact that a substantial percentage of the additional interest was simply a reflection of the rate of inflation and, consequently, represented an equivalent erosion of the value of their capital. If, on the other hand, they chose to put their funds in investments which emphasized capital gain, this almost inevitably resulted in a reduction in income and increased the value of their funds and, at the same time, reduced their disbursement requirements.

Effective from January 1, 1984, the *Income Tax Act* rules were amended by a lengthy process of false starts and negotiations, initiated by MacEachern's budget of November, 1981. The final result left the original disbursement requirement (based on 80 per cent of receipted donations for the prior year) effectively unchanged for all charities. It did, however, totally change the conceptual basis of the second test although in the final result, the test remained applicable only to foundations. It removed the test based upon "income" and substituted a test based on the value of the foundation's investment fund. Four and one-half per cent of this value is now the minimum disbursement requirement.

Some studies have indicated that the four and one-half per cent payment, if past experience is repeated, will result in the erosion of the capital value of the investment fund: historically it has seldom been possible to achieve this return and also achieve an additional return sufficient to offset inflation. While this is doubtless a conclusion which individual investment managers will challenge as simply a reflection of market averages rather than their professional capacity, not every charity uses the services of investment managers and the uncomfortable truth is that the success or failure of a manager is something which can only be ascertained after the fact.

The primary consequence of the new calculation is that it is no longer related to income. The amount of income is immaterial. The amount of capital gain is also immaterial. The charity is free to achieve as much return as it can without regard to the source, be it capital gain or earned income. With this change, investment strategy need no longer be inhibited by either the handicaps or the opportunities which the previous disbursement quota provided. The foundation is free to follow whatever investment strategy it considers appropriate.

This encourages utilizing the tremendous flexibility available in investment management. The total portfolio can be in shares, bonds, mortgages, term deposits, gold bars, or whatever happens to be considered appropriate for market conditions. Funds can be shifted from one category to another and from one investment in a particular category to another without complications arising from either the *Income Tax Act* or the income earned—there are none. The potential now exists for decisions affecting the investment portfolio to be based entirely on investment management principles without distinction between capital and income and measured solely by overall return on investment.

The first consequence of this new situation is that the directors of foundations are faced with the necessity of adopting a new approach to their continuing responsibilities for making donation decisions and, in addition, complying with the minimum requirements of the *Act*.

In the past these decisions would, consciously or unconsciously, be interlocked. The decision to make a donation would be based upon the availability of income from which to make it, or the investment in the portfolio would be determined by the level of donations which the board had decided to make. This interlinkage is no longer justified by the *Income Tax Act*.

The minimum level of donations to be made by the foundation is, for the first time, established by the *Act* at the commencement of each fiscal year and the directors are responsible for setting their own level of expenditure at, or in excess of, that figure. They have far greater opportunity now than in the past to arrive at this decision in an orderly and thoughtful manner.

This freedom of choice can be a mixed blessing. As the old lag said when he returned to prison: there were too many decisions out there. To arrive at a decision about the size of the foundation's donations can lead to fundamental questions about the justification for the existence of the foundation and its continued perpetuation. The opportunity to establish an investment policy can also expose foundations to a bewildering variety of investment theories, all of them plausible and all of them challenged.

There are also some separate and unresolved challenges to this apparent freedom of choice. The first challenge can be expected to come from the accounting profession. If those responsible for formulating new investment policies set aside previous investment practice and switch the funds from equities to term deposits and back again, what unpredictable results will this have on the annual financial statements and the comparative results year to year? One must anticipate astounding increases or declines on a historic basis in the categories of income, capital and capital surplus. While it is certainly within the accountants' capacity to adopt some stated basis for the accounts and use a form of market-value accounting, they may also have a justifiable hesitancy about doing so.

Another group by whom this question must be considered is the lawyers. To them is given the responsibility of reading and, more onerous yet, applying any operational limitations on the charity which may be imposed by its charter of incorporation, by-laws, deeds of donation, and trust deeds, as well as by regulatory bodies independent of Revenue Canada. It can safely be assumed that the amendment of an *Income Tax Act* disbursement quota will not be accepted as sufficient authority to depart from accepted accounting, legal or regulatory principles.

Are any of these concerns more than the reflections of an over-anxious disposition? Let us pick away at some of these general statements, which sound so ominous, and see. The charter of a foundation may state that the capital is not be be spent without the consent of the foundation members. A donor of a particular fund may specify that only the income of the donation may be used. Funds may be collected for a specific and specified purpose. None of these is an unusual situation. To what extent will these limitations, whether self-imposed or imposed by others, be breached if all investment funds are treated as an undifferentiated amorphous mass from which the directors dip out, from time to time, a percentage which they happen to consider to be appropriate? The simple answer is that no one will know unless the accounts differentiate between income and capital and between funds which are designated for specific purposes and those which are not.

The first question is whether your accountants will agree to such a process. It will at least stimulate a discussion if you ask whether they, as skilled figure jugglers, can construct a set of annual statements which will obliterate the historic categories they have been applying and simply distinguish assets and liabilities rather than capital and income. Their models already exist in pension fund accounts.

The second question is whether your lawyer will agree. A similar question addressed to this skilled word juggler is certain to provoke a spirited response.