

Solutions to the 20-Per-Cent Problem

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All registered charities are required by the provisions of the *Income Tax Act* (the *Act*) to have exclusively charitable purposes. In order to ensure that most of a charity's funds are used for such purposes, the *Act* requires compliance with annual minimum expenditure tests. To look at it another way, the expenditure tests are designed to discourage inappropriate surplus accumulations and to keep administrative expenses, such as fund-raising costs, at a reasonable level.

In general terms, a charity must expend directly on charitable activities in a particular year, at least 80 per cent of certain donation revenues from the previous year. Conversely, no more than 20 per cent of such revenue can be used for surplus accumulation and administrative expenses. Here lies the "20-per-cent problem" that a charity must contend with in complying with its statutory requirements.

This is a very broad overview of the problem. The actual statutory disbursement requirements are far more complex and contain additional tests and exemptions. Furthermore, the requirements vary depending upon the type of charity, i.e., whether the charity is classified as a charitable organization, public foundation or private foundation. The balance of this article will, therefore, focus on the disbursement requirements in more detail and on practical solutions to the 20-per-cent problem.

Disbursement Rules

(a) Results of Non-Compliance

The disbursement requirements definitely need to be taken seriously as non-compliance gives Revenue Canada the authority to revoke the charity's registration and levy a penalty tax of up to 100 per cent. These consequences are rather harsh and would only be invoked in extreme situations: Revenue Canada is usually prepared to be reasonable and to allow a charity sufficient time to rectify its errors if disbursement problems have occurred. Nevertheless, it is not a pleasant situation to be caught offside and not be in a position to get back on track without great difficulty.

(b) Specific Rules

As already noted, the disbursement rules differ for each of the three categories of charity. The differences reflect the government's attitude towards the potential for abuse in each type of charity and what it expects of charities in return for their special tax status and ability to issue tax-deductible receipts.

(i) The 80-Per-Cent Rule

The first disbursement requirement, which applies to all charities, is that at least 80 per cent of the previous year's donations for which an official receipt was issued, must be expended in the year on charitable activities carried on by the charity itself or by way of gifts made to qualified donees (a category which includes other registered charities, registered Canadian amateur athletic associations, prescribed universities outside Canada, the United Nations or its agencies, certain foreign charities, certain non-profit corporations in Canada, and Canadian governments).

Certain donations can be excluded from the 80-per-cent rule and these include:

- a gift of capital received by way of bequest or inheritance;
- a gift received subject to a trust or direction to the effect that the gift be held for a period of not less than 10 years;
- a gift received from another registered charity.

A gift from another charity is not really an exclusion as it is subject to its own disbursement requirement unless it is classified as a "specified gift", i.e., is specified by the donor charity as not being an eligible disbursement for its own disbursement requirements and, in turn, it is not included in determining the disbursement requirements of the recipient charity. The "specified gift" provision will be useful where the donor charity wants to make a capital gift to a charitable foundation in circumstances where it does not want that foundation to be required to spend the gift in the following year.

If a gift from another charity is not "specified", then the recipient charity must expend at least 80 per cent (100 per cent in the case of a private foundation) of the gift by the end of the following year.

(ii) The 4.5-Per-Cent Rule

In addition to the 80-per-cent rule, public and private foundations have another disbursement requirement which is based on their investment assets and effectively forces a minimum rate of return on these assets. The requirement is based on 4.5 per cent of the value of such assets subject to a rather complex formula and set of calculations.

(iii) The 50-Per-Cent Rule

Charitable organizations have a special requirement as well in that they are not allowed to disburse more than 50 per cent of their incomes in a particular year to qualified donees. The reason for this rule is that such organizations are supposed to be actively involved in directly carrying on charitable activities as opposed to acting as conduits for donations to other charities, which is really the function of a foundation. This 50-per-cent rule can be avoided in certain situations where two or more charities have substantially the same aims or activities and obtain from Revenue Canada the designation of "associated charities". As a result of this designation, a

charitable organization could donate more than 50 per cent of its income to an associated charity.

(iii) *Qualified Disbursements*

In reviewing the above disbursement requirements, it becomes abundantly clear that one of the key issues is: what qualifies as a disbursement? For all registered charities, a qualified disbursement must be an expenditure on charitable activities carried on by the charity itself or, alternatively, a gift to a qualified donee.

The latter type of disbursement is straightforward but the former raises concerns and issues. An expenditure on charitable activities involves a substantial subjective element, i.e., deciding what constitutes a "charitable activity", and there is very little guidance on this subject in the *Act* and in the various publications which have been circulated by Revenue Canada.

Revenue Canada views "non-charitable expenditures" as including fund-raising expenses and management and general administration costs of a support nature which are other than costs incurred to accomplish the charity's programs directly. This view raises a number of questions and can be open to challenge as possibly being too vague and broad. Most active charities which are not involved in significant outside fund raising will contend that all their expenses fall into the category of "charitable" for the purpose of their disbursement requirement.

A major exception to the above is found in the *Act* which states that an expenditure is not a qualified disbursement if it is an expenditure on political activities. Although these are not defined in the *Act*, Revenue Canada interprets political activities for this purpose as being efforts to influence and mobilize public opinion on an issue for the purpose of pressuring elected officials to take a certain course of action. Partisan political activities involving the support of, or opposition to, a political party or candidate for public office are expressly prohibited.

It is possible for a charity to have qualified disbursements in excess of the amount required to meet its disbursement quota. This excess can be carried back one year or forward five years to help solve disbursement shortfall problems in those years.

Solutions to Disbursement Problems

Most active charities should not experience any major problems in complying with the statutory disbursement requirements. Nevertheless, unusual situations may arise which require careful advance planning and action.

One of the easiest methods of minimizing problems is to limit the issuing of official receipts whenever possible. For example, such receipts should not be issued to a donor who is unlikely to require an official receipt for tax purposes. This category would include non-residents of Canada, a business which can justify the expense as business promotion as opposed to a donation, or a non-taxpaying donor.

Alternatively, where there appears to be a problem in disbursing donations within the required time period, the charity could request that donors attach the 10-year retention designation to their gifts. This designation is extremely important for charitable foundations which are generally organized to build up capital and disburse only their investment income.

Another solution to a potential disbursement problem is the use of a special provision in the *Act* whereby a charity can apply to Revenue Canada for permission to accumulate property for a particular purpose, such as the purchase or construction of a building. If permission is granted, then the property set aside and any income generated on that property are deemed to have been expended on charitable activities.

When a charity is considering potential sources of income it is obvious that non-receipted income from sources such as government grants, fund-raising events, investments, and lotteries is very important and should be maximized. Substantial revenue from these sources allows a charity to increase its wealth and enjoy some breathing room without an offsetting obligation to disburse the funds quickly.

If the charity is a foundation, it should be kept in mind that it has an additional requirement to disburse 4.5 per cent of its investment assets. Accordingly, a foundation needs to pay particularly close attention to the investment of its funds and ensure that a reasonable rate of return is being generated.

On the expenditure side, a charity can minimize its risk of exposure to a high level of so-called non-charitable expenses through the use of volunteers for administrative and fund-raising activities. Of course, this strategy is not always practical but, nevertheless, it needs to be kept in mind by those charities which make limited expenditures on charitable activities.

Because of the one-year time lag between the year in which the funds are received and the year in which the funds must be expended, there should be enough time for advance planning and budgeting for the necessary expenditure of donations. Charities should ensure that their accounting systems are adequate and up-to-date in order to deal properly with the need for advance planning.

Where a charity is confronted with a serious shortfall in its disbursements which cannot be corrected by any of the previously described solutions or by use of a disbursement excess from another year then, as a last-ditch measure, the charity can apply to Revenue Canada for permission to reduce its disbursement requirements for a particular year. However, Revenue Canada will only consider approving such a request in special circumstances such as a difficult start-up period for a new charity or when a charity has experienced a disastrous fund-raising project.

Conclusion

Compliance with the disbursement requirements can be a complex and

frustrating exercise. However, with careful planning and understanding of the rules, serious problems should be avoided. Revenue Canada appears to be paying more attention to charities and their activities and making it more difficult for new charities to obtain registration. Once registered, it is important for all types of charity to safeguard their registered status by never losing sight of the statutory requirements and, in particular, those pertaining to the disbursement of funds.