

BUDGET 2022: SIGNIFICANT CHANGES TO THE ADMINISTRATION OF CHARITIES ARE ON THE HORIZON

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In Budget 2022, the Minister of Finance (Canada) (the "Minister") proposed several significant revisions to the *Income Tax Act* (Canada) (the "Tax Act") that will impact the administration and reporting obligations of registered charities. If implemented, these changes will, among other things, force Canada's larger registered charities to expend a greater proportion of their assets each year under the so-called "disbursement quota" rules (generally increasing required annual expenditures from 3.5% to 5% of assets not used directly in charitable activities or administration), and will also facilitate and streamline the administration and documentation of registered charities' relationships with non-profits organizations (other than "qualified donees") that are providing beneficial services in the community or abroad.

Disbursement Quota Proposals

Existing Regime

The Tax Act generally requires registered charities to expend a minimum amount each year at least equal to their "disbursement quota" (as defined in subsection 149.1(1) of the Tax Act). Currently, the disbursement quota rules generally require a registered charity to expend on charitable activities (or gifts to "qualified donees") in a particular taxation year an amount at least equal to 3.5% of the average[1] amount of property owned by the registered charity over the 24 months immediately preceding such taxation year that was not used directly in charitable activities or administration (prorated for short taxation years), subject to certain de minimis exemptions for the first \$100,000 of assets owned by a "charitable organization" or the first \$25,000 of assets owned by a "charitable foundation", each as defined in the Tax Act.[2]

The existing regime provides the Canada Revenue Agency (the "CRA") with discretion to authorize a registered charity to accumulate property for a particular purpose, on terms and conditions and over any period of time specified in the CRA's approval. Any property accumulated in accordance with such written authorization is generally not counted in determining a registered charity's disbursement quota. [3]

Similarly, the Tax Act currently provides the CRA with authority to relieve a registered charity of all or a portion of its obligations under the disbursement quota regime in a particular year. Where such relief is granted, the



registered charity is deemed to have expended an amount on charitable activities equal to the amount of disbursement quota relief granted by the CRA.[4]

Historical Developments

Historically, the disbursement quota rules required a greater level of expenditures than the current 3.5% threshold. However, the regime was substantially relaxed for taxation years ending after March 3, 2010 to its existing 3.5% level. This reduction in the disbursement quota better permitted registered charities to accumulate funds for certain major capital projects, while also better ensuring that registered charities could make well-considered financial decisions to facilitate the prudent and efficient spending of resources, without the pressure to expend amounts in a rushed or ill-considered fashion to ensure compliance with the disbursement quota regime.

In the 2021 Budget, the Minister announced that the government would be undertaking public consultations with the charitable sector to discuss increasing the disbursement quota to address what the government perceived as excessive accumulations of capital by certain registered charities and the mismatch in timing between the immediate tax deductions available to donors on amounts donated to registered charities and deferred spending on charitable activities by such registered charities. [5]

Of particular note, the government's consultation materials made reference to international comparisons showing that other jurisdictions, such as the United States and Australia, have established minimum expenditure limits for private foundations that approximate 5% of a charity's net assets, subject to the particular rules in place in each such jurisdiction.

Proposed Amendments in Budget 2022

Budget 2022 proposes to increase the disbursement quota from its existing rate of 3.5% to 5% for the portion of property not used in charitable activities or administration that exceeds \$1 million. The purported intent for elevating the disbursement quota is to acknowledge that smaller registered charities may face barriers to achieving the same investment returns as larger charities.

Further revisions announced in Budget 2022 will more clearly establish that expenditures for administration and management are not considered qualifying expenditures on charitable activities for purposes of satisfying a registered charity's disbursement quota obligations.

Budget 2022 also proposes to adjust the manner in which the CRA may offer registered charities discretionary relief from their disbursement quota obligations. In the name of increased transparency, Budget 2022 proposes to amend the mechanism by which the CRA can grant a registered charity discretionary relief from its disbursement quota obligations pursuant to subsection 149.1(5) of the Tax Act (as described above), by



specifying that such relief will take the form of a reduced expenditure obligation, rather than deeming certain unexpended amounts to have been expended for purposes of determining compliance with the disbursement quota regime. Budget 2022 also proposes to authorize the CRA to publicly disclose any such relief that has been granted from the disbursement quota obligations (presumably to be included in the CRA's publicly searchable online charity database).

Budget 2022 further proposes to eliminate the CRA's discretion to authorize a registered charity to accumulate property that will not be counted towards the disbursement quota (as described above), as currently described in subsection 149.1(8) of the Tax Act. The Budget 2022 materials indicate that such discretion is no longer necessary in light of the 2010 amendments to the disbursement quota and the CRA's ability to grant discretionary relief.

While the proposed revisions to the disbursement quota regime could, in the short term, increase funds made available by registered charities (particularly charitable foundations) to charitable organizations and other charitable beneficiaries, the proposed increase in the disbursement quota and the proposed elimination of the accumulated property regime will generally make fundraising by registered charities for capital projects more difficult and increase the risk that charitable funds will be expended in a wasteful or imprudent manner as registered charities are forced to expend funds in circumstances when such funds would not otherwise have been spent.

Notably, the long term reduction in interest rates since the relaxation of the disbursement quota rules in 2010 has generally reduced charities' ability to earn low-risk investment returns. Since neither the existing 3.5% disbursement quota rate (nor the contemplated 5% rate) makes any accommodation for changes in interest rates, certain registered charities have struggled to expend sufficient amounts in recent years without depleting previously accumulated capital or have otherwise had to hold a greater proportion of capital in riskier asset classes in order to maintain accumulated capital pools. Increasing the disbursement quota rate will only further increase the pressure on registered charities, potentially exposing such registered charities to greater investment risk.

This increased pressure on registered charities' capital accumulation strategies is all the more troubling in light of the trend in recent decades for governments to offload responsibility for construction of public infrastructure (e.g., hospital wings and university buildings) to private fundraising.

The government has not yet released draft legislation that would implement the above changes. However, the Budget 2022 materials indicate that such revisions will take effect for fiscal periods beginning on or after January 1, 2023 (with a transitional rule in respect of applications for CRA authorization to accumulate property filed prior to January 1, 2023).



Charitable Partnerships

Existing Regime

Registered charities in Canada are currently permitted to expend resources in one of two ways: (i) on charitable activities they carry on themselves; or (ii) by gifting funds to "qualified donees" as defined in the Tax Act (which generally include "registered charities", as well as certain other organizations to which donations are generally eligible for a tax credit or deduction, as applicable).

This limitation on the manner in which registered charities can expend resources reduces registered charities' flexibility in working with organizations that are not "qualified donees" (including most non-Canadian charities and tax-exempt, non-profit organizations in Canada that have not applied to be, or are ineligible to become, a registered charity or other qualified donee). In such circumstances, the current rules require that, where a registered charity does not operate its programs directly, but instead retains others to perform activities on its behalf, the registered charity must maintain sufficient control and direction over the activities of the intermediary and the spending of funds disbursed to the intermediary such that the expenditures of the intermediary can be considered expenditures of the registered charity for such purposes.

The CRA has published administrative guidance setting out the CRA's expectations for how a registered charity should maintain control over funds spent by an intermediary entity. [6] Typically, such control will be maintained by the registered charity through one or more contractual agreements that give the registered charity sufficient and appropriate oversight over the property transferred to the intermediary (which oversight rights might include, but are not limited to, audit rights, the obligation to produce periodic performance reports, and the right to performance evaluations). Although such contractual arrangements permit registered charities to work with a broader array of partner organizations than simply qualified donees (which ability can be particularly valuable when working in certain foreign jurisdictions or when providing disaster relief), such control agreements are frequently criticized as excessively cumbersome and inflexible.

Although a registered charity gifting funds to another registered charity or qualified donee will occasionally include contractual terms relating to the post-gift use of the funds, such contractual arrangements are not a requirement in the case of gifts to qualified donees, and are consequently much less common than in circumstances where transfers of property are to intermediaries that are not qualified donees.

Proposed Amendments in Budget 2022

Budget 2022 proposes to amend the Tax Act with the stated aim of improving the efficiency and administration of working relationships between registered charities and organizations that are not qualified donees. The proposed revisions will allow registered charities to make eligible disbursements to organizations



that are not qualified donees, provided that such disbursements are in furtherance of the registered charity's charitable purposes. To ensure that the registered charity (and the CRA) are adequately positioned to maintain oversight over such expenditures, Budget 2022 proposes compliance measures that would need to be taken at the outset of the working relationship between the registered charity and any such grantee (and during the term of the working arrangement) to ensure funds disbursed to the grantee are appropriately devoted to charitable activities.

The Budget 2022 materials suggest that the proposed reporting and compliance obligations will include:

- a required pre-grant inquiry to obtain reasonable assurances that the registered charity's resources will be used for the purposes set out in the written agreement (including a review of the identity, past history, practices, activities and areas of expertise of the grantee);
- a written agreement between the registered charity and the grantee, which must include (i) the terms and conditions of the funding provided, (ii) a description of the charitable activities that the grantee will undertake, (iii) a requirement that any funds not used for the purposes for which they were granted be returned to the registered charity, and (iv) record retention policies that require records relating to the use of the registered charity's resources be maintained and remain accessible for a minimum of six years following the end of the relevant taxation year;
- monitoring and oversight of the grantee, including periodic (minimum of annually) reports on the use of the disbursed funds and compliance with contractual terms, with provision to take remedial action as required;
- full and detailed final reports from the grantee, which include information that outlines the results achieved, details how the funds were spent, and provides sufficient documentary evidence to demonstrate that funds were spent appropriately. The registered charity would also be required to demonstrate that these final reports and supporting documentation were reviewed and approved by the registered charity; and
- registered charities would be required to disclose on their annual information return information relating to grants above \$5,000 (which would presumably be posted to the CRA's publicly searchable online charity database).

To backstop compliance, Budget 2022 proposes amendments to the Tax Act entitling the CRA to demand that registered charities take all reasonable steps to obtain receipts, invoices, or other documentary evidence from grantees to which a registered charity has disbursed funds to demonstrate disbursed funds were spent appropriately.

The Budget 2022 materials note that the new regime could increase the risk of a registered charity acting as a



conduit for donations to other organizations. Such conduit relationships typically refer to the practice of a registered charity issuing donation receipts to donors where an understanding exists that all, or a substantial portion, of the donated funds will be disbursed to a particular organization other than a qualified donee. The CRA has previously raised concerns that such practices could lead to abuse, since charitable tax deductions/credits are being claimed in respect of funds flowing to an organization that may not qualify on the merits as a registered charity, and is not subject to the CRA oversight applicable to registered charities. To combat the potential elevated risk of such conduit arrangements, Budget 2022 proposes to extend the application of paragraph 168(1)(f) of the Tax Act to registered charities, which currently provides that a registered Canadian amateur athletic association or registered journalism organization can lose its respective registration if it accepts a gift the granting of which was expressly or implicitly conditional on the association or organization making a gift to another person, club, society, association or organization.

The government has not yet released draft legislation that would implement the above changes. In addition, the Budget 2022 materials indicate that "[a]dditional measures designed to ensure compliance by charities with these new rules are forthcoming". Registered charities that work with organizations other than qualified donees will need to wait to review the draft legislation and supplementary rules before evaluating the benefits of this new regime. While the CRA has a legitimate interest in ensuring that charitable funds are appropriately spent, the compliance obligations associated with this new regime may be sufficiently similar to existing control agreements entered into between registered charities and intermediaries (other than qualified donees) such that they result in limited net efficiency gains.

The Budget 2022 materials indicate that such proposals will take effect upon Royal Assent being granted to the enacting legislation.

- [1] The methodology for calculating this average amount is set out in section 3701 of the *Income Tax Regulations* (Canada).
- [2] A "disbursement excess", as defined in subsection 149.1(21) of the Tax Act, which generally refers to expenditures on charitable activities (or gifts to "qualified donees") in a particular calendar year in excess of a registered charity's disbursement quota obligation for the year, may generally be credited against the registered charity's disbursement quota obligation for the immediately preceding taxation year or one of the immediately subsequent five taxation years.
- [3] Subsection 149.1(8) of the Tax Act.
- [4] Subsection 149.1(5) of the Tax Act.
- [5] The government consultations were launched on August 6, 2021.
- [6] See, for example: <u>CG-004</u>, <u>Using an intermediary to carry on a charity's activities within Canada, June 20</u>, <u>2011 (Revised November 27, 2020)</u>, and <u>CG-002</u>, <u>Canadian registered charities carrying on activities outside</u>



Canada, July 8, 2010 (Revised November 27, 2020).

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A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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