The Disbursement Quota Rules: Looking Back on the 2010 Changes

The Disbursement Quota is a hot topic in the charitable world.   There are strong advocates for changing the existing rules, most notably raising the 3.5% minimum spending threshold on long-term assets. So given this renewed attention on the DQ, I thought it might be fun to take a little trip back to when the DQ rules received their last major update.

The 2010 Federal Budget introduced provisions which radically impacted the Disbursement Quota rules and had far-reaching implications for charities. These provisions reformed and simplified the disbursement quota rules, and forever impacted the conversations that gift planners (and all fundraisers) have with their prospective donors.

Prior to 2010, the DQ rules were complex and challenging.   While the elimination of the most onerous disbursement quota provisions was thunderously applauded, it did mean a new learning curve for fundraisers. These are the changes that were introduced. Ah, memories!

Item #1: Elimination of the Charitable Expenditure Rule

The 2010 Changes eliminated the “80/20” rule for ordinary receipted donations. Charities were no longer be required to spend 80% of receipted donations on charitable activities by the end of the year following the issuance of the receipt.

Administrative Implications:

This was good news for charities. Small and rural charities, especially those that received the bulk of their funding from tax-receipted donations as opposed to government grants or sponsorships, often had difficulty meeting the disbursement quota requirements.

Under the changes, charities were no longer be required to closely monitor their receipted versus non-receipted donations. They were also able to accumulate donations for the purpose of raising funds for longer-term projects (and were even be permitted to exclude these accumulated gifts from the 3.5% provision outlined below).

The 80/20 rule was originally introduced to curtail administrative spending by charities and ensure an appropriate portion was spent on charitable activities. Although it was repealed, charities are still required by law to “devote their resources to charitable activities”. Over the past few years, the Charities Directorate has engaged the charitable sector in a discussion about the level of expenses that are reasonable for charities to incur. The result was the introduction of new Fundraising Guidelines (which will not be discussed in this paper). The Fundraising Guidelines are designed to ensure that charities continue to engage in charitable activities. The absence of the 80/20 rule does not mean charities can now arbitrarily and without sanction spend their funds on administration.

Key Point #2: Elimination of "Enduring Property"

Enduring property was eliminated as well as the "ten-year" gift which excluded lifetime donations from the 80/20 formula if the capital was held for a minimum of ten years.

Administrative Implications:

The rules around enduring property were incredibly burdensome for charities, especially the requirement that each ten-year gift be tracked individually. No longer will charities have to track the expiration of ten-year gifts for the purposes of a disbursement quota calculation or manage the fine line between ten-year and perpetual gifts. This will also allow charities to spend unrestricted gifts on their own timetable, reflecting the actual needs of their own programs and activities. This has had major implications for the structuring of charitable gifts.

Of course, charities will likely still have to comply with the terms of their existing endowments and the documents under which they were created.

Item #3: Elimination of "Capital Gains Pool"

The "capital gains pool" was repealed. The capital gains pool was essentially a notional tracking of a charity's realized capital gains. While it provided charities with somewhat more flexibility with respect to meeting their disbursement quota obligations, it also provided administrators with an unending source of head-scratching.

Administrative Implications:

Many charities did not implement the capital gains pool, due to their investment policy, record-keeping systems, and lack of understanding. The capital gains pool concept also imposed a set of administrative rules that was, in my opinion, contrary to prudent investing. It dictated that capital gains be crystallized and the proceeds held outside the charity's main investment portfolio to enable capital to be used for charitable purposes according to a complex formula. Many charities did not implement the capital gains pool, due to their investment policy, record-keeping systems, and fundamental lack of understanding. At the time, I said that I'd rather jump in the pollution-infested waters of the Erie Canal than wade into the murky ones of capital gains pool. Good riddance. The proposed new regime provides the flexibility without the complexity and I hear the Erie Canal is slowly getting cleaned up.

Item #4: Retention of the Capital Accumulation Rule

Charities must continue to spend on charitable purposes an amount equal to at least 3.5% of eligible property owned in the 24-month period prior to the current year (that is, property not used directly in charitable activities or for administration). This is effectively unchanged from previous rules. However, charitable organizations with less than $100,000 (up from $25,000) in eligible property are exempt as are foundations with under $25,000 in such property.

Administrative Implications:

Charities must continue to manage and track their eligible (sometimes referred to as "investable") property. It is important to note that charities must take a rolling average of their property held in the 24-month period prior to the current year. This figure may different significantly from charity's *current* eligible property due to market fluctuations, additional donations and grants.

These changes had a significant impact on a charity's investment policy. The flexibility introduced by the 2010 rules allow donors to disburse the capital from the gifts on a different schedule. What happens if a million-dollar donor asks the charity to use the donation over a five-year period (let's say $200,000 per year) instead of using only the income over a longer-term period. This request, along with others like it, should cause the charity to rethink its investment objectives (time horizon being an important component of investment objectives) and therefore its asset mix and investment policy. Charities may wish to consider the introduction of "spend-down" funds into their policy mix – a middle category between immediate use and endowment. Charities will also have more of an opportunity to build reserve funds or quasi-endowments, which are managed like endowments but with access to capital, as needed.

Finally, the new rules eliminated an inherent conflict between the governing rules of trustee investment legislation (typically found in provincial Trustee Acts) and the Income Tax Act. Trust legislation generally calls for charities to adhere to "prudent investor" standards which often result in a focus on total return investing (where the total return of the portfolio is the prime focus, rather than what generates these returns). The old DQ rules required a focus on income generation whereas the new regime allowed the charity to engage in total return investing without regard to the tracking of income and capital.

Item #5: Strengthening of Anti-Avoidance Rules

Key Point:

The 2010 budget also introduced some other changes around inter-charity transfers, which will be ignored for the purpose of this article because these changes have had limited impact on donors.

Existing gifts

Existing gift agreements should have been reviewed in order to determine whether or not they can be amended to reflect the rule changes. In cases where the gift arrangement can be amended and the original donor is still alive, it may be prudent to discuss with the original donor whether they would be interested in revisiting the current terms of the gift. Charities will also likely want to see the actual legislation before taking any drastic action on existing gifts.

Conclusion:

It is critical for charitable personnel (including senior volunteers) to familiarize themselves with the disbursement quota rules because of the potential of these new rules to affect not only how we administer the charity but how we discuss giving with our potential donors. And as the rules look like they are changing again, it is important that charities understand how they apply to them.