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Backgrounder

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# Firm Foundations

## *Putting Private and Public Foundations on Level Ground*

A. Abigail Payne

### The Backgrounder in Brief

*Private foundations exist so Canadian donors may pursue charitable activities through long-lived institutions organized to achieve those goals. Public policy should encourage Canadians to pursue their visions.*

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Charitable organizations play an important role in Canadian society. They provide beneficial goods and services not undertaken by government or the private sector. These organizations, however, rely on the support of private donors, whose contributions fund the goods and services provided by public and private foundations and other charities.

To encourage donor support for socially desirable charitable activity, governments provide charities with favorable tax status. For one thing, donations to organizations involved in grant-making or direct provision of charitable goods and services are eligible for federal and provincial tax credits against the donor's income tax liability. For another, charitable organizations can receive tax exempt status, enabling them to raise revenue for the services they provide without incurring income tax. In cases where individuals donate to organizations with which they have a close relationship, it raises the question of whether they — and the receiving body — should face a greater level of regulatory scrutiny than would occur if they had an arm's-length relationship. Underlying this issue is the potential for abuse of the tax system.

Individuals seek a variety of non-taxable ways to share their wealth with their communities. One method is through the use of foundations. Foundations give donors the greatest control over the use and investment of their donations and a means to promote both current and future charitable activities.

Charities have different levels of restrictions and limitations based on how the Canada Revenue Agency (CRA) classifies them. The key is whether the organization is a grant maker or a service provider. If 50 percent or more of an organization's activity is devoted to grant-making (supporting other registered charitable groups), CRA designates it as a foundation and it is subject to more limits than if the primary purpose was service provision.

Because many foundations are controlled by a few individuals, such as a family, CRA delineated foundations into public and private organizations. The assumption underpinning this distinction is that if a foundation is closely controlled there is more room for abuse of the organization — and it therefore merits greater scrutiny. Foundations are classified as private if there is a close link between the donors and the foundation.

While the objective of providing greater scrutiny of closely held foundations seems reasonable, what is less clear is whether the current rules actually prevent serious abuse of the tax system. Also unclear is whether the potential growth of private foundations has been damped because of the current regulatory system or because of the tax treatment of donations to private foundations.

Private foundations may be established for a relatively small sum. According to Philanthropic Foundations Canada, in 2003 there were approximately 2,290 active grant-making foundations in Canada. About 82 percent of the foundations are run by families. The total assets controlled by all Canadian private foundations are valued at some $12 billion. By comparison, the total assets held by U.S. private foundations are more than $400 billion.

Currently, the CRA treats private foundations differently from public ones for permitted business activities, as well as for the assumption of debt, the receipt of non-qualifying securities and the treatment of donated property. But many of the restrictions placed on private foundations do not appear to address serious threats

of abuse by these organizations and there is scant evidence of abuse of the tax system by private foundations.

The current system of oversight and regulation of charitable organizations is under review. The latest round of revisions to the sector occurred in the March 2004 federal budget, which established a Charities Advisory Committee to advise the national revenue minister. The budget also reaffirmed the federal government's commitment to establishing a new not-for-profit-corporations act, which received first reading in November 2004. In addition, the Standing Senate Committee on Banking, Trade and Commerce has examined issues surrounding charitable donations.

Many of the initiatives expressed in the federal budget draw on government reports that focused on ways to update the rules on the establishment of a charitable organization, registration for tax purposes, and the regulation of registered charitable organizations. Those reports discuss transparency in charitable activities, the role of administrative costs, the need for financial instruments for charitable organizations, and capacity-building. Glaringly absent, except from Senate of Canada (2004), is any discussion of how and why private foundations are treated differently from public ones and from other charitable organizations. As I will discuss, the current rules regarding the treatment of private foundations are not easily justified from an economic perspective and should be reevaluated just as other aspects of the charitable sector are reassessed. This is acknowledged in Senate of Canada (2004), where the standing committee called for an appropriate governance and monitoring system for private foundations. The committee also emphasized the importance of encouraging charitable giving.

This Backgrounder explores the current regulatory environment and the link between the treatment of private foundations and the potential for abuse of the tax system by private foundations and their contributors. I discuss why private foundations exist and outline potential abuses that might be used to justify greater scrutiny of private versus public foundations. I then explore the current differences in the regulatory treatment of private foundations and donations to them and whether the current level of scrutiny is justified.

Private foundations not only support current charitable activities, they help provide a potential bedrock of future funding for these activities. Government should encourage, not discourage, their development. While abuse must be discouraged, the regulations and tax provisions for foundations should focus more on strengthening them. Regulation should be limited to providing for increased transparency in their finances and activities. These include filing of financial returns, reporting on the uses of funds and the names of organizations that receive financing, as well as information on foundation employees who are closely connected to donors.

Such information should be in a format readily accessible by government and the public. Promoting access to information will lower the costs associated with detecting and investigating potential abuses, as well as acting as a deterrent.

The tax provisions should be similar to those for charitable organizations and public foundations. With respect to less transparent types of donations, such as shares in closely held corporations, governments could allow for similar treatment

across all types of registered charities, while subjecting private foundations to a slightly greater level of scrutiny.

## Why Do Private Foundations Exist?

Part of the confusion surrounding the best way to regulate private foundations stems from the lack of a clear theoretical understanding of their nature and functions.

People's motivations for donating to charities are a good place to start. Two important and non-exclusive drivers are the desire to be altruistic — donors perceive a need and do what they can to meet it — and to leave a legacy. Gifts often come from anonymous donors; in other cases, donors see a need and want to show their community that they responded to it. A private foundation is likely to reflect donors who prefer to see their names associated with their charitable donations. Yet this motivation alone is insufficient to support the existence of private foundations.

A second element in a foundation's makeup is the extent to which it enables donors to control their donations. A donor always has general control over the good or service provided — through the choice of a particular charitable organization. Someone interested in funding a homeless shelter would not give to an organization with the primary purpose of displaying art. Within an organization, donors can have limited control over the use of their gifts: Donor-advised grants have become a popular vehicle for large donations. Under this type of donation, however, givers may only advise an organization, which remains the sole decision-maker in the ultimate use of the funds. Private foundations add a layer of control for the donors. Although the funding is ultimately given to a charitable organization, it may be easier for foundations to exert control over funds than if an individual donation were given directly.

A third component relates to time: not all donations are used for current activities. Foundations can control both the way in which current donations are invested and the distribution stream. For example, a foundation can decide how deeply to dip into principle when current income is low. Within charitable organizations funds may be donated, invested and the income used to finance subsequent activities. In this case, however, once donated to a charitable organization, it is the organization, not the donor, that controls the investment and use of funds.

Of the three components, it is only the first — the reasons for giving — that distinguishes private from public foundations. Alone, this is insufficient to justify greater scrutiny or differential tax treatment of private foundations. Because of the differences between private and public foundations, the first component illustrates the fact that foundations are private institutions that serve public purposes. While foundations are established to carry out the wishes of their donors, not all donor desires necessarily serve the public or are legal, and regulation should discourage people from using private foundations to their personal advantage. Balanced regulation would help prevent abuse of the tax system through private foundations, while encouraging potential donors to use them as vehicles for

providing charitable goods and services not offered by existing charities, public foundations or governments.

## How Private Foundations Could Be Abused

Whether a foundation or the donations to a foundation should be subject to tighter regulation depends on the degree of concern about possible abuse, such as the foundation's financing and other activities being used to further the interests of the primary donor rather than putative beneficiaries.

Abuses that raise concern include the possibility of donors steering foundations' business activities to improve their own income; using foundations to provide business services to firms related to the donor, or generating tax credits for donations that in fact represent payment for taxable services. Other possibilities include using foundations to shift tax-sheltered income or benefits among family members, steering business assets into foundations while retaining effective control and deriving financial benefits from control of those businesses.

These possibilities do not all require the use of private foundations, nor are they necessarily legal under current tax law. They do, however, point to the need for a minimum level of regulatory oversight of charities and foundations. The issue is whether the potential for abuse justifies the regulatory differences that exist for private versus public foundations and other charitable organizations.

## Differences between Foundations and Charitable Organizations

Foundations represent a subset of charitable or not-for-profit organizations. In general, foundations are designed to collect and then distribute at least 50 percent of their income to registered charitable organizations. Foundations can carry out their own activities, such as conducting scientific research or operating museums, or they can function as grant-making entities. Other charitable organizations directly provide charitable goods or services.

A foundation must be established under a provincial or federal corporation statute.[1] It must also register with CRA to obtain charity status and to issue receipts for tax purposes. CRA has become the effective regulator of foundations and charitable organizations (Monahan and Roth 2000), (Phillips, Chapman and Stevens 2001).

## Restrictions on the Operation of Foundations

As with all charitable organizations, foundations must devote their resources to charitable purposes and activities directed at a significant portion of the public at

1 The corporations statute does not distinguish between charitable organizations and foundations. Discussions about potential revisions, however, have focused on such issues as making the activities of the organizations more transparent and providing indemnification for officers and directors of the organizations. There has been no real effort to use the corporation statutes for regulating the operations of organizations as they relate to grant-making and service delivery activities.

large. A foundation devoted to the benefit of a private club or a particular individual would not qualify for tax-exempt status. Charitable activities must fall under one or more of the following categories: poverty relief, advancement of education, advancement of religion, or other beneficial community activities deemed charitable by a court. Foundations and charitable organizations may not pay income to members except to cover a reasonable salary or out-of-pocket expense.[2]

Foundations may not acquire control of other corporations.[3] They may not acquire debts other than those related to current operating expenses, purchase and sale of investments, or administration. Restrictions on income recipients, ownership of other corporations and debt acquisition constitute attempts to promote transparency in a foundation's operations.

## *Public and Private Differences*

Private foundations receive stricter scrutiny and are subject to more restrictions then public foundations. The key distinction is whether there is evidence of operational control of the foundation by one or a few related individuals, or if such a group is the foundation's dominant source of donations. The default classification is as a public foundation. To receive stricter scrutiny, a foundation must fail either the test of control or the test associated with the source of donations to the foundation.

To determine who is in control, CRA focuses on the relationship among directors, trustees, officers and the foundation. If more than 50 percent of the directors, trustees and officers do not have an arm's-length relationship to the foundation, then it is a private foundation. The term arm's-length refers to whether an individual acts independently of the foundation. For example, if a family establishes a foundation and a director of the foundation is one of the family members, this director would not have an arm's-length relationship; the determination can be quite difficult to make.

CRA examines the source of the foundation's donations. If more than 50 percent of capital is contributed by one individual or group of related individuals, the foundation is treated as private. This factor has been historically difficult to avoid for gifts of unrealized appreciated property and large donations. Following 2002 changes to the *Income Tax Act*, a donation can cause a foundation to be classified as private only if the donor who controls the charity represents more than 50 percent of the directors, trustees, officers, or similar officials and the donation represents more than 50 percent of the foundation's capital.

Under current rules, the prime determinant of a private foundation's status is the control of the foundation's operations. Historically, donors could exert the most amount of control over their donations if they established their own

2 For more details on the legal requirements for qualifying as a foundation or charitable organization, see http://www.cra-arc.gc.ca/tax/charities/policy/policies_list-e.html#Becoming%20a%20Registered%20Charity.

3 Control is defined as owning 50 percent or more of the corporation's issued share capital and having full voting rights.

foundation. Today, it is possible to exert control over the use of a donation to charitable organizations and to public foundations through donor-advised grants. Thus, if donors want to retain some control over the use of gifts, they do not have to establish a private foundation. But while a donor may provide advice on how the funds should be used, however, the charity retains control over the ultimate use of the funds. Donor-advised gifts to public foundations and charitable organizations are not subject to greater scrutiny by CRA or any other government agency. That raises the question of whether donations to private foundations still require a higher level of scrutiny.

Is there something different about gifts to a donor-controlled foundation, as opposed to a strings-attached donation to a non-private foundation? The historical concern was that private foundations would not distribute their funds freely or would delay provision of charitable goods and services while providing a current tax deduction or credit. This concern is alleviated by the disbursement quotas all foundations face. Thus, controlling a foundation does not necessarily raise the prospect of abuse that would imply a private foundation ought to be treated differently from a public one.

## Additional Scrutiny for Private Foundations

If controlling a foundation warrants additional regulatory scrutiny, what kind is warranted? Current scrutiny applies to unrelated business activities, donations of non-qualifying securities, disbursement quotas and the level of tax credit available for some types of donations. The only scrutiny that makes sense is with respect to non-qualifying securities.

### *Restrictions on Business Activities*

Charitable organizations and public foundations may engage in business activities if they are directly related to charitable goods or services. Private foundations are prohibited from engaging in any type of business activity; they must operate exclusively for charitable purposes. But the scope of this restriction seems more onerous than justified from an economic perspective. For example, although public foundations and charitable organizations are permitted to operate gift shops, book stores, parking lots and other activities that are related to the foundation or organization, a private foundation established for purposes similar to a public foundation cannot. Recalling the potential abuses cited earlier, while some types of business activities should be prohibited, it is not clear that private foundations should be prohibited from engaging in all of them.

### *Differences in Disbursement Quotas*

All charitable organizations must balance the use of their resources between current and future charitable goods and services. CRA requires all organizations to disburse a minimum amount of their income each year. Disbursement quotas vary by type of organization. In meeting its quota, a charity can include only funds

spent directly on charitable activities or on gifts to qualified organizations. Neither management and administration costs nor funds spent on political activities and fund-raising expenditures can be included in calculating the disbursement quota.

An organization's disbursement quota calculation begins with identifying the pool of funding. Money received by the organization in the preceding year is included in the base amount. Excluded are gifts of capital through a bequest or inheritance, gifts subject to a trust or to direction by the donor that the property be held by the charity for not less than 10 years, and gifts from other registered charities. In the base amount are gifts that were previously excluded, but were spent in the previous year. A foundation must also include in its base amount all gifts received from other registered charities during the previous year, except those designated by the foundation as a "specified gift" in its tax return.

The disbursement quota for charitable organizations and public foundations is 80 percent of the base amount. Foundations must also include 4.5 percent of the average value of their assets over the previous 24 months that were not used directly in charitable activities or in administration. The March 2004 federal budget proposed reducing the amount to 3.5 percent.

The disbursement quota for private foundations can be slightly more than the disbursement quota for public foundations. If private foundations do not receive funds from other registered charities then the disbursement quota is the same as it is for public foundations. If the private foundation receives funds from other registered charities in the preceding tax year, the foundation must disburse all funds from this source of revenue.

Again, the reason for this special treatment of private foundations is not clear. If the expectation is that funds transferred from one organization to another should be spent, then this should apply across all types of charities. The risk is that setting too high a disbursement quota will unduly shorten a foundation's effective life, possibly preventing Canadians from fulfilling the socially desirable long-term goals they would otherwise seek.

## *Classification Effects on Charitable Donations*

Because foundations are a subset of registered charities, one should expect the tax status of donations to be the same regardless of the classification of the organization as a charitable undertaking, public or private foundation.[4] For the most part, this is the case; donations to a registered charity qualify for a tax credit for individuals or a deduction for corporations.[5] There are two exceptions: For one

4 Charitable trusts are established under provincial law.

5 There is a limit on the taxable benefit from charitable donations for individuals and corporations. In general, individuals are limited to a maximum charitable donation of 75 percent of annual net income. If the tax return is for a deceased individual, however, the limit of the charitable donation credit is 100 percent of net income for the year of death. Any excess donations for a deceased's return may be used for the year prior to death, in which case the donation credit is also 100 percent of net income. For more details concerning the tax treatment of charitable donations, the Canada Customs and Revenue Agency's website is comprehensive (http://www.cra-arc.gc.ca/tax/charities/menu-e.html; in addition, the following publications provide more information regarding charitable donations: Carter (2003); PricewaterhouseCoopers (2003).

thing, gifts of non-qualified securities will not be treated as tax deductible donations if the gifts are to a private foundation; for another, the tax credit for gifts of appreciated property is treated differently depending on the classification of the receiving organization.

### *Restrictions on Donations of Non-qualifying Securities*

Private foundations face greater restrictions on their ability to receive gifts of non-qualifying securities. Non-qualifying securities include shares that are not listed on an established stock exchange and are shares in a company with which the donor does not deal at arm's-length, as well as obligations such as debts owed to the donor by a company with which the donor does not deal at arm's-length. Non-qualifying securities may be treated as a tax-recognized donation if the security is in the form of a share, the donor deals at arm's-length with the charity, and the charity receiving the gift is a charitable organization or public foundation.

If a private foundation receives a non-qualifying security it may not issue a tax receipt for the donation. A tax receipt can be issued only when — within five years of the receipt of the donation — the foundation sells or disposes of the security, or it ceases to fall within the definition of a non-qualifying security, such as when a private company becomes public. This type of restriction only makes sense if the lack of an arm's-length relationship with a foundation could encourage abuse of the foundation's operations.

Donating shares of a privately held corporation to a foundation makes sense when donors can avoid tax on the capital gains associated with the donation and the gains are used for charitable purposes. As long as they remain in the possession of the foundation, however, these shares must generate sufficient income to meet the disbursement quotas discussed earlier.

The current restrictions on a private foundation's ability to issue a tax receipt are unfair if the foundation uses the proceeds from the shares for charitable activities. It is conceivable that the donation of a privately held corporation's shares could unduly benefit someone who does not have an arm's-length relationship with the foundation. This could be addressed by requiring the foundation to be more explicit in its transactions, allowing for the clear identification of activities between the foundation and individuals who lack an arm's-length affiliation with the foundation (or donor). Thus, by having more focused regulation, governments could permit private foundations to issue tax receipts for non-qualifying securities under limited circumstances. By modifying the regulations in this manner, the government would provide more incentives for the establishment of private foundations and the donation of more sources of funding.

### *Treatment of Gifts of Appreciated Property*

Donating appreciated property to a registered charity triggers a disposition for tax purposes. Across all types of recipient organizations, the general rule is that 50 percent of the gain in the property's value is taxable as a capital gain if the

property is donated. Thus, if an individual's marginal tax rate on capital gains is 40 percent (the rate varies by province), that person will only be taxed at a rate of 20 percent on the gain attributed to donated property.[6]

In the late 1990s, qualifying gifts of property were given an additional tax benefit if the donation was to an organization other than a private foundation.[7] Qualifying gifts have been defined as marketable securities that include shares, bonds, warrants and options if they are listed on a prescribed exchange; mutual fund shares and units and segregated fund units and prescribed debt obligations. For these types of donations, 25 percent of the capital gain is deemed taxable if the donation is to something other than a private foundation.

Under the old rule, a gift with an unrecognized capital gain would be taxed at 20 percent, or 40 percent of 50 percent of the capital gain. Under the new rule, if the gift is to a charitable organization or a public foundation, the individual will only incur a capital gains tax of 10 percent. If the gift is to a private foundation, the individual's capital gains tax remains at 20 percent.

Numerous philanthropic groups, such as Philanthropic Foundations Canada, have recently argued for an end to the less charitable treatment accorded to appreciated gifts to private foundations. These arguments were accepted by the Senate committee, which said that equal treatment should be offered on a "trial basis and subject to the resolution of governance and monitoring systems as well as self-dealing concerns" (Senate of Canada 2004).

## Putting Private and Public Foundations on Level Ground

In many respects, CRA treats private foundations differently from public foundations. These differences, however, do not appear to be based on sound economic grounds. This raises the question: why are private foundations treated differently? The key distinction between a private and public foundation is that a private foundation is run by individuals who lack an arm's-length relationship with the foundation. In most cases, the principle donor is also associated with running the foundation. Given this distinction, regulatory differences should be focused on activities that could be abused when there is a strong relationship between the operation of the foundation and a donor, one that could provide the donor with a potential benefit that extends beyond the tax credit.

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6 For certain types of appreciated property the donor need pay no capital gains tax. These include such gifts as Canadian cultural property. The Canadian Cultural Property Export Review Board determines whether a donated property should be considered a Canadian cultural property and confirms the fair market value of the property. To qualify, the property must be considered of "outstanding, significant, and national importance," and it must be donated to a designated Canadian museum, art gallery, archive, or library. In addition to not triggering a taxable gain, donors may claim up to 100 percent of their net income for this type of donation. As well, there are exemptions provided for gifts of ecologically sensitive land, certified by the Ministry of the Environment, given to Canadian municipalities and certain types of registered charities. Donors pay 25 percent of their marginal tax rate for capital gains and may claim up to 100 percent of net income as a donation in a given year.

7 Introduced as a trial measure, the change was made permanent in 2002.

Of the current restrictions, two could help discourage abuse: limiting the donations of non-qualifying securities and the restriction on some business activities. Issuing tax receipts for non-qualifying securities should be prohibited, however, only to the extent that they are associated with a non-arm's length activity.

Regulation should be targeted at promoting greater transparency in foundations' activities, by providing detail on three specific aspects. First, information on financial transactions should be publicly available; reporting a foundation's finances will allow for easier identification of potential abuses. Second, information on a foundation's charitable activities should be publicly available. This would include identifying the recipients of charitable funding and information that can help identify the relationship between the foundation and the recipients of the funding, such as related members of the board of directors of the different registered charities. Third, information on the individuals working for, and closely associated with, the foundation should be publicly available. This type of information would include such things as the relationship between the foundation's employees and contractors and the donors to the foundation.

Some transparency is already provided for in the current regulations. If, however, the CRA promoted greater transparency and required information to be publicly available, the overall regulatory burden — which restricts foundations' abilities to conduct socially desirable activities — could be reduced. The information must be readily accessible; governments have little incentive to tightly monitor registered charities because there is little financial incentive for revenue agencies to do so. The need for such a monitoring role shrivels when financial and other transactions are conducted in plain sight.

Private foundations exist because Canadian donors perceive a need to pursue particular charitable activities through long-lived institutions organized to achieve those goals. Public policy should facilitate Canadians' efforts to pursue their visions — and putting private and public foundations on level ground would improve their ability to do so.

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