CAGP

**Written Submission to the Department of Finance**

**"Consultation: Boosting Charitable Spending in our Communities"**

**Submission By:**

**The Canadian Association of Gift Planners**

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## Recommendations

1. That Finance and CRA re-consider the reasons why certain registered charities may have a spending issue because in many cases where lack of spending is an issue, there is no relationship between the lack of spending and the amount of the DQ. Instead, CAGP recommends reframing the public discussion and consultation on a charitable model that promotes the broadening of social impact by registered charities to a more diverse group of donees, including grassroots organizations and community organizations that are not qualified donees but are otherwise carrying out programming deemed charitable by law.

2. That CRA assist registered charities with their compliance of their DQ obligations, promote data quality for the charitable sector and promote transparency and accountability by charities through more complete reporting of their assets not used in charitable activities or administration, the computation of a charity's specific DQ that is integrated with the charity's T3010 *Registered Charity Information Return*, and more fulsome information on a charity's investments, including program-related investments and social impact investments, and on its endowed funds and donor-advised funds.

3. That the federal government mandate and invest in more robust and accurate data collection so that matters like periodic reviews of the DQ rate be based on data-backed analysis of future projections of net investment returns, asset growth rates, and payout rates that will support predictive and positive social impact outcomes for charitable beneficiaries whilst still allowing charities to properly budget for the deployment of charitable resources in a timely but optimal way.

4. That CRA expand its policy and administrative position to support of the movement by registered charities to do their charitable work and achieve certain social outcomes for the betterment of society and its constituents with the additional tool of making social impact investments, program-related investments, and other mission-related investments.

CAGP is pleased to provide this submission to Finance as part of its consultation entitled: *Consultation: Boosting Charitable Spending in Our Communities*.

## Public Needs Heightened by COVID-19

The COVID-19 pandemic has impacted every facet of Canadian society, including the charitable and non-profit sector, which has experienced heightened pressure and demands for essential services and community investment. A recent survey of Canada's charitable sector indicates that the impact of the pandemic has been uneven with 42% of charities experiencing demands for their services and programs in excess of their capacity and available resources.[1] 20% of Canadian charities believe that their financial situations will worsen in the coming months and just under 25% of charities suspect that they will be unable to sustain operations for more than 12 months.

The charitable sector has supported individuals, families, and communities throughout the pandemic by playing a focused role in supporting public health and social services. The sector's umbrella organizations have tracked the behaviours of Canada's grantmaking foundations and funders over the course of the COVID-19 pandemic, noting major shifts in their funding to adapt to needs of the communities that have been exasperated by the pandemic. In one COVID-related survey, 15.5% of respondents reported having reallocated their existing budgets to provide COVID-19 funding, 12.6% used funds from their endowments, and 7.9% used additional funds from donations.[2] These pandemic period granting levels demonstrate that charities pivoted in the face of great needs of the communities they serve and reorganized their affairs to spend and disburse well above minimum disbursement rates without prompting by government authorities or a change to the statutory DQ rate.

What is particularly clear is that the pandemic has laid bare the social, health, and economic inequalities of Canada's most vulnerable communities and populations; inequalities that pre-existed the pandemic but have been amplified by COVID-19.

Although Canada's charities have targeted organizations and activities most impacted by the pandemic, most of the COVID-19 related funding was received by qualified donees. Despite a conscious effort by Canada's funders to look for ways to support grassroots community organizations and equity-seeking organizations, many of these organizations are not qualified donees and consequently, continue to be disproportionately under supported by the charitable sector. Amongst those unsupported organizations are those that support Black and Indigenous populations and/or are Black or Indigenous-led. This result is an inherent outcome of Canada's framework for registered charities, which considers that a registered charity has properly fulfilled its charitable mandate if it makes grants to qualified donees and/or carries out its "own activities", but not if it grants funds to organizations that are not qualified donees. Therefore, the charity framework in Canada provides for a natural bias that deploys charitable resources to qualified donees. CAGP asserts that the blunt instrument of an increase to the DQ rate will not cure the funding gap experienced by grassroot organizations and community organizations that themselves are

[1] *Imagine Canada's* Sector Monitor survey, published August 17, 2021
[2] *Philanthropic Foundations of Canada's* ongoing COVID-19 survey; COVID Survey Report November 2020

not qualified donees.

The Emergency Community Support Fund (ECSF) which was the federal government's investment to support charities and non-profit organizations that serve vulnerable populations, had a significant portion of the $350 million fund deployed to qualified donees. The experience of ECSF is good evidence that the statutory DQ rate for Canadian's charities does not guarantee a proportionate distribution of philanthropic resources to the most needy and vulnerable communities. The DQ in its current form is not a lever which can address this gap, whether the statutory disbursement rate is set at 3.5% of undeployed assets or at a higher rate.

## Philanthropy in Canada

It is no secret that the sector is facing challenges. In particular, the number of donors is declining while demand for charities' programs and services is increasing exponentially. Charities need donors and a vibrant philanthropic environment to be able to deliver their critical programs and services.

In many respects, Canada benefits from a legislative and regulatory system that supports charitable giving at the donor level. However, many factors that impact registered charities, such as their ability to deploy resources in compliance with minimum spending obligations under the DQ regime, also have a direct impact on donors and their ability to contribute new funds to the charitable sector. Those factors have historically included marketplace conditions and investment returns.

Notwithstanding that the 20-year historical investment returns on a traditionally-weighted portfolio by asset class for a typical Canadian charitable foundation may have been approximately 5.6% (before considering investment advisory fees)[3], it is the expected future investment returns that will impact philanthropy in Canada in the coming years. It is estimated the expected future investment returns for a similarly weighted portfolio will yield approximately 4.1% gross returns before investment fees. Assuming 0.5% investment advisory fees, long-term investment returns for charities with investable assets of 3.6% will challenge charities to be able to sustain their operations and payouts without depleting capital. Likewise, private donors may also experience similar declines in market returns in the next ten years with the consequential impact that the amount and pace of new funds into the charitable sector may decline and/or slow.

CAGP respectfully submits that the current framing of the government's policy to increase charitable spending and community investment solely through a single mechanism such as the DQ rate is unadvisable without due consideration of the unintended impacts that an increase to the DQ rate might have on charities' ability to carry out their programs, on donors' ability to continue funding charities, and on the beneficiary groups that charities will not be able to service.

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[3] Based on weighting of asset returns by asset category for a representative Canadian charity with investable assets as provided in a survey of *Philanthropic Foundations Canada* member foundations.

**Unintended Consequences of Changes to the DQ**

The question of how charities can reach more Canadians in need is a critical one. This question should, very rightfully, be at the forefront of our national discourse.

Some of the unintended consequences of a statutory adjustment to the DQ rate without appropriate data collection and analysis include the following:

(a) Depletion of Financial Assets

Donors are very concerned about possible legislative and regulatory measures that risk devaluing and/or depleting charities' endowments and investments, particularly if donors have made endowed gifts (with charities accepting the legal obligation not to spend the capital of the gift in some cases) or wish to make endowed gifts so that the capital contributions are there to sustain the charity's good work into the future.

The DQ has a significant and direct impact on charities' investing behaviours, including their asset allocations, risk tolerances, and target investment returns. Realized investment returns affect a charity's sustainability and its ability to continue to operate into the extended future. Consequently, the DQ rate is one tool available to the federal government to balance its desire to increase the pace of resource deployment by charities with the ability of charities to preserve sufficient capital, to earn long-term investment returns on this capital, and to ensure that they have sufficient resources to fund charitable programs and grants well into the future. This strategy considers that charities will continue to work to attract new contributions from private donors, recognizing that private donations represent an unguaranteed and unreliable income stream.

(b) Myth of Investment Returns and Hoarding of Assets

Part of the public discussion surrounding the DQ rate has been triggered by the incorrect assertion that charitable foundations are hoarding assets at the expense of charitable spending. This discourse is potentially damaging to the reputation of the charitable sector and discouraging to the philanthropic movement in Canada.

To provide context, we refer to investment returns as presented in Exhibit A for the 2021 year of 19.3%. Using 2021's investment returns as the basis for establishing a DQ rate for 2022 is just as flawed as using the 2009 investment returns of -21.5% for the same purpose. Both 2021 and 2009 are outlier years.

The myth around the investment returns realized by Canadian charitable foundations relative to their minimum disbursement obligations and actual payout rates, would be dispelled if four factors or facts are considered:

1. Investment returns should be considered over a period of more than one year and certainly, not when the market has experienced a volatile year.

2. The loss lag effect is real and impacts spending capacity.

3. Annual investment returns should be stated on a net basis to take into account the costs of investment administration.

4. Charities that voluntarily or involuntarily spend down their resources over a short period of a few years, do not increase the amount of charitable giving but rather cause aggregate charitable giving to decrease over the long term as a consequence of the depletion of the asset base.

In general, net investment returns, growth rates, and spending/payout rate data is incomplete for the sector as a whole but has been analyzed for discreet groups of charities based on general commonalties. However, to illustrate these assertions, we use the data of one of Canada's largest community foundations, referred to herein as Community Foundation (CF) in Exhibit A.

CF's investment returns over a 19-year period averages 5.7% per annum. The realized investment return is lower than its stated investment objective of 7%. The target investment return is based on the need to fund a 5% spending rate and a 2% inflation allowance to ensure that CF's spending holds its monetary power. Exhibit A tracks a $100,000 capital gift over a 19-year period, assuming an annual payout on charitable activities and grants to qualified donees of 5% and a 0.5% investment administration charge. Administration fees are mandatory on invested assets and therefore are paid from investment returns. In 2004, when the DQ rate was reduced from 4.5% to 3.5%, the bank prime interest rate was 4.25% before taking into account administration fees. In 2020, the bank prime interest rate was 2.45%. The DQ rate of 3.5% was not set in 2004 in contemplation that investment returns would be 3.5% but was selected to acknowledge that interest rates were declining. This is an argument for a periodic review of the DQ rate that it considers a number of data points, including mid- and long-term projected investment returns, asset growth, payout rates, and administration fees.

The illustration in Exhibit A provides for average investment returns of 5.7%, and aggregated payout/distributions and administration fees of 5.5%, leading to the expectation that capital growth is 0.2% per annum (a rate that does not even maintain spending power). In fact, capital does not grow but declines to $95,456 because of the 'loss lag' effect. To illustrate the impact of the 'loss lag', assume CF's investment returns are 10% in year one and +20% in year two, and that CF spends are 5% per annually. Based on capital of, say, $10,000 in year one, a 10% investment loss and 5% spend or payout results in capital falling from $10,000 to $8,500. In year two, investment gain of 20% (i.e., 20% x $8,500 or $1,700) together with a 5% spend or payout (i.e., 5% x $8,500 or $425) results in remaining capital at the end of year two at $9,775, which is less than the opening capital of $10,000. Overall, the illustration shows that while CF incurs investment losses in five of its years, its capital actually declines in seven of those years after taking into account its annual distributions/payouts and administration fees.

In short, charitable foundations in Canada are not hoarding assets and, at best, are maintaining the purchasing power of their capital. More likely, many charitable foundations are not realizing returns that allow them to maintain capital after inflationary adjustments.

As a consequence, Canadian charities have adapted by moving to more sophisticated investment portfolios that include equities and alternative investments in order to (i) achieve investment returns that can produce cash flows to support their charitable programs and granting, and (ii) minimize the loss lag effect so that they can continue to service communities without unduly shortening their service lives. The tradeoff of moving to a balanced or equity-heavy portfolio are the greater risks of loss that charities are exposed to as well as market value volatility.

A policy that focuses on a faster deployment of charitable resources into the sector through a singular tool like the DQ rate, is one that forces charities into a spend-down mode. Depending on the charity and its operating model, this is not necessarily optimal for the nature of the charitable work or programming that it is carrying out. A "one size fits all" model is not appropriate for a diverse charitable sector such as the one in Canada, and does not respect the autonomy that charities need to plan and execute in a manner that maximizes their societal impact, and which reduces the number of years that the government can rely on charities to help service communities and beneficiaries in need.

(c) Administrative Burden

Donors are equally concerned about measures that risk causing unnecessary administrative burdens for charities, particularly when they perceive that administrative costs are funded from investments. Transparency about a charity's administrative costs is paramount to building and maintaining the trust with the charity's stakeholders, including its donors, contributors, and beneficiaries.

Again, there is a balance to be struck between improving charities' compliance with the current minimum spending obligations through better reporting by charities and helping charities manage their administrative costs that arise from the incremental reporting through Form T3010 *Registered Charity Information Return* and through other reporting mandates.

Enhancing the quality and nature of data regarding the impact that charities have on the true social and economic benefits for Canadian society at large and improving transparency regarding charities' social contract with the federal charity regulator regarding its minimum spending obligations may include:

- more precise reporting of DQ obligation, DQ excesses and shortfalls of charities as part of its T3010 reporting
- enhanced reporting about a charity's top charitable programs
- enhanced reporting about a charity's long-term investments, including Social Impact Investments (SIIs), Program-Related Investments (PRIs), Mission-Related Investments (MRIs), etc. so as to properly demonstrate the benefit of a charity's investments in these vehicles that achieve social benefits and so that 'qualifying PRIs' can be exempted from DQ obligations
- enhanced reporting about a charity's arrangements with non-qualified donees and investments made to achieve certain social impact

(c) Long-Term Financial Viability

A charitable sector that is forced to apply its financial resources to the "here and now" as opposed to being able to plan for its long-term sustainability as an effective and reliable entity that serves charitable beneficiaries, is a model for the sector which aligns with the federal government's vision of the role that charities play in the broader society.

However, a deeper understanding is required of the economics of how granting charities (which feed funding into operating charities) will respond to a change in the DQ rate as it relates to their impact strategy and investment strategy.

(d) Political Solution

The framing of the issue as being related to the DQ suggests that there is a quick, "band-aid" solution to a very complex and real public concern.

(e) Data-Supported Ways to Increase Investment

Through CAGP's work with its members and partners in the sector, we understand that there are many data-driven ways to increase spending and investment through charities in support of Canadian in need.

(f) Autonomy of Charities

The issue of the pace of deployment of charitable resources into the sector should not be an impediment to a charity having the autonomy and flexibility to:

- plan for (new) charitable programs and/or to identify qualified donees that will carry out the charitable programs which align with the charity's mandate;
- manage its asset bases;
- optimize its resources for the delivery of charitable programming; and
- accumulate its investable assets to accommodate substantial charitable projects.

The public consultation on the DQ has brought to the forefront a broader discussion about the entire regulatory and policy framework that the charitable sector operates within and how a modernization (of more than the DQ rate) is needed to more efficiently direct charitable resources to the most vulnerable and marginalized persons in society.

## CAGP Recommendation

Considering the foregoing, CAGP is recommending:

1. That Finance and CRA re-consider the reasons why certain registered charities may have a spending issue because in many cases where lack of spending is an issue, there is no relationship between the lack of spending and the amount of the DQ. Instead, CAGP recommends reframing the public discussion and consultation on a charitable model that promotes the broadening of social impact by registered charities to a more diverse group of donees, including grassroots organizations and community organizations that are not qualified donees but are otherwise carrying out programming deemed charitable by law.

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fulsome information on a charity's investments, including program-related investments and social impact investments, and on its endowed funds and donor-advised funds.

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4. That CRA expand its policy and administrative position to support of the movement by registered charities to do their charitable work and achieve certain social outcomes for the betterment of society and its constituents with the additional tool of making social impact investments, program-related investments, and other mission-related investments.

## Conclusion

We believe the recommendations we are bringing forward will help ensure charities continue to benefit from the generosity of donors so they can continue to support individuals, families, and communities across Canada through much-needed charitable spending and investment.

Thank you for your consideration of these recommendations.

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**About CAGP**

The Canadian Association of Gift Planners (CAGP) is a leading national, non-profit organization established in 1993 whose purpose is to champion the growth and development of strategic charitable gift planning in Canada. A cornerstone of our mission is a 25-year history as a voice for the charitable sector, advocating for a beneficial tax and legislative environment that supports charitable giving and maximizes the impact of charitable gifts.

Our national membership, engaged in our 20 Chapters across the country, is comprised of over 1,300 charitable gift planners, as well as individuals from a variety of allied professions in the private sector, including law, trust and estate planning, accounting, life underwriting and financial planning.

Exhibit A Review of 17 Years of Investment Returns, Effect on Capital

| year | return % | opening capital | income | grants 5% | fees 0.50% | ending capital |
|---|---|---|---|---|---|---|
| 2022 | | 95466 | | 4773 | 477 | |
| 2021 | 19.3 | 83889 | 16190.58 | 4194 | 419 | 95466 |
| 2020 | -2.2 | 90887 | -1999.51 | 4544 | 454 | 83889 |
| 2019 | 3.9 | 92365 | 3602.235 | 4618 | 462 | 90887 |
| 2018 | 7.8 | 90288 | 7042.464 | 4514 | 451 | 92365 |
| 2017 | 9.2 | 87067 | 8010.164 | 4353 | 435 | 90288 |
| 2016 | -3.2 | 95364 | -3051.65 | 4768 | 477 | 87067 |
| 2015 | 9 | 92139 | 8292.51 | 4607 | 461 | 95364 |
| 2014 | 11.8 | 86678 | 10228 | 4334 | 433 | 92139 |
| 2013 | 8.5 | 84153 | 7153.005 | 4208 | 421 | 86678 |
| 2012 | -0.1 | 89145 | -89.145 | 4457 | 446 | 84153 |
| 2011 | 8.4 | 86633 | 7277.172 | 4332 | 433 | 89145 |
| 2010 | 16.3 | 78189 | 12744.81 | 3909 | 391 | 86633 |
| 2009 | -21.5 | 107108 | -23028.2 | 5355 | 536 | 78189 |
| 2008 | 0.8 | 112390 | 899.12 | 5620 | 562 | 107108 |
| 2007 | 10.2 | 107345 | 10949.19 | 5367 | 537 | 112390 |
| 2006 | 10.8 | 101942 | 11009.74 | 5097 | 510 | 107345 |
| 2005 | 5.6 | 101840 | 5703.04 | 5092 | 509 | 101942 |
| 2004 | 16.8 | 91500 | 15372 | 4575 | 458 | 101840 |
| 2003 | -3 | 100000 | -3000 | 5000 | 500 | 91500 |
| | | | | | | |
| | 108.4 | | | 88946 | | |
| ave. return | 5.7 | | | | | |