

PRIVATE AND PUBLIC FOUNDATIONS

Charitable Foundations, which can be either private or public, can be effective vehicles for charitable giving.

This Reference Guide provides an overview of some of the important information that should be considered regarding establishing and donating through a private foundation and donating through a public foundation.

GENERAL

Both public and private foundations must be registered as charities under the federal *Income Tax Act*. Registration exempts the foundation from paying income tax and also allows the foundation to issue official tax receipts to donors, which the donors can then use to reduce their own taxes through the charitable donation tax credit (or deduction), as discussed below.

The primary difference between a private and public foundation is that a private foundation receives most of its funding from one person or from related persons, while a public foundation has a broader source of funding.

If an individual and his or her family intend to make significant charitable donations into the future, they may wish to do so through a *private foundation*. The individual and family members would then make donations to the private foundation during their lives and/or through their Wills, rather than directly to other charities. The private foundation would then disburse the funds to other registered charities as and when the directors or trustees determine (subject to meeting the annual disbursement quota discussed below).

As an alternative to establishing a private foundation, an individual who intends to make a significant charitable contribution may consider making a “*designated gift*” to a public foundation, if permitted by the public foundation. Typically, with a designated gift, the public foundation would agree to accept a gift subject to the condition that the donated funds are kept in a separate sub-fund, with the income from the sub-fund to be distributed in perpetuity either to a specific organization, for a specific purpose or for a specified area of interest.

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PRIVATE FOUNDATIONS

BENEFITS OF CREATING A PRIVATE FOUNDATION

There are many benefits of establishing a private foundation, both philanthropic and tax-related.

Philanthropic Benefits

Larger Gifts

Since a private foundation is a tax-exempt entity, the income earned on amounts donated to it will accumulate free from tax. This allows for a greater amount to be available for ultimate distribution to charitable organizations. In addition, as a result of the tax savings available to donors through the use of the charitable donation tax credit or deduction (discussed below), the use of a private foundation can often allow an individual and his or her family to make larger charitable gifts than they may have thought possible.

Control Over Timing

The use of a private foundation allows donations to be made at the convenience of the donor (for tax or other reasons) rather than at the convenience of the charity.

Unified Family Giving

A private foundation allows all family gifts to be made through one identifiable entity. Depending on the family's intentions, this entity can be used either to publicize gifts that the family has made or to provide anonymity for the donors, if that is what is preferred.

Living Legacy

A private foundation can provide the individual with some degree of certainty that his or her charitable objectives will continue to be achieved on a long-term basis and will be carried forward to future generations. Members of the family can be involved in the foundation at various levels, for example as donors, as directors or trustees, or even as employees of the foundation.

Tax Savings

Charitable Donation Tax Credit or Deduction

As noted earlier, the tax savings that can be achieved through the use of a private foundation arise through either the charitable donation tax credit or the charitable donation deduction.

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As a registered charity, a private foundation will issue donation receipts for amounts donated to it. These receipts entitle the donors to claim either a tax *credit* (in the case of individual donors) or a tax *deduction* (in the case of corporate donors).

In general, during lifetime, a donor can claim a charitable donation tax credit of up to 75% of the donor's net income in the year of the donation. Any unused portion of the receipt can be carried forward for up to five years. There are also special rules that apply on a donor's death that permit a donation receipt to be used to offset 100% of the donor's income in the year of death, with any excess allowed to be carried back to reduce taxes in the year immediately preceding the year of the donor's death. As well, gifts of certified cultural property and qualified ecological property entitle the donor to a 100% limit.

Further information regarding the charitable donation tax credit can be found in our Reference Guide on Charitable Giving.

Property That Should Not Be Donated

The *Income Tax Act* of Canada includes some anti-avoidance measures to prevent an individual who establishes a foundation (or a corporation that establishes a private foundation) from exerting control over the foundation to obtain funds from the foundation without paying the foundation an appropriate rate of return.

For example, if an individual donates any of the following to a private foundation:

- ❖ Shares issued by a private corporation controlled by the individual, or a right to acquire such shares; or
- ❖ Debt issued by a private corporation controlled by the individual or owing by a person who is a member, shareholder, trustee, settlor, officer, official or director of the foundation or a person who does not deal at arm's length with any such member, shareholder, trustee, etc.,

the individual will not be allowed to claim a charitable donation tax credit for the donation, as these are considered to be non-qualifying investments for the private foundation. However, if such a gift is made, the tax credit may be claimed if (and when) the foundation disposes of the non-qualifying investment within 60 months of the gift or if the security ceases to be non-qualifying.

In addition, a penalty tax is imposed on the taxpayer who owes the debt to the foundation or on the corporation whose shares are involved.

ESTABLISHING A PRIVATE FOUNDATION

If you are considering establishing a private foundation, you should be aware of what is involved in creating and operating a private foundation.

Corporation or Trust?

A private foundation to be established by an individual could be set up either as a *corporation* or a *trust*. There are some key differences between these two types of entities. The choice of which entity to use will typically depend on administrative and operational requirements and on the individual's personal preference.

Corporation

A corporation would be incorporated under the relevant provincial or federal legislation that govern corporations. For ease of administration, we generally recommend that federal incorporation be avoided.

The corporation would be established without share capital and would have a board of directors as well as members. The members could be a defined group of people, such as individuals related to the person creating the foundation by blood, adoption, marriage or common-law relationship. The main responsibility of the members would be to vote for the board of directors from year to year.

As a result of certain *Income Tax Act* requirements regarding the directors of a charity, there must be a minimum of three directors for a charity. The directors would be charged with managing the charitable activities of the corporation. In turn, the directors could appoint or hire a manager or administrator and delegate many of the day-to-day activities to that person. As indicated above, the manager or administrator could be a family member if desired. Subject to the various statutory exceptions regarding unpaid taxes, source deductions and wages, the directors would generally be protected from personal liability in respect of actions taken by the corporation.

Trusts

A trust is an entity that is governed by statute, the common law and the agreement under which it is created. To establish a charitable trust, an individual (referred to as the "settlor") would generally transfer an initial sum of money to trustees, who would hold the money in accordance with the terms of a trust agreement. The trust agreement would set out, among other things, the powers and duties of the trustees, as well as the charitable purposes of the trust.

In order to meet certain requirements under the *Income Tax Act* regarding the trustees, there must be a minimum of three trustees for a charitable trust. The settlor (that is, the individual who made the initial contribution) could be one of

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the trustees, but for tax reasons should not have control over the decisions of the trustees.

Annual Requirements

There are different annual reporting and filing requirements, depending on whether a foundation is established as a corporation or as a trust.

For example, a corporation must file annual returns with the applicable incorporating authority (whether federal or provincial) and must hold annual meetings or pass annual resolutions. There are no similar obligations for a trust.

However, both a corporation and a trust have to file information returns with Canada Revenue Agency (the "CRA") every year.

Registration

The private foundation, whether created as a trust or a corporation, must be registered with the CRA.

In order to register the foundation, an application must be submitted to the CRA in the form required. Certain documents and information must be submitted along with or as part of the application form. This includes the governing documents of the foundation, a list of its directors or trustees, an estimated budget for the first fiscal year of the foundation and information about the activities of the foundation, showing how the foundation intends to achieve its goals. An individual would want to consult his or her professional advisors for assistance in preparing the application and the accompanying material.

For straightforward applications (such as those for foundations whose objects are clearly charitable), the CRA will usually require several months to process the application.

OPERATIONAL AND ADMINISTRATIVE REQUIREMENTS FOR A PRIVATE FOUNDATION

The following are some important operational and administrative requirements involved in establishing and operating a private foundation:

Charitable Purposes

A private foundation must be organized and operated exclusively for charitable purposes. The common law defines a charitable purpose to mean:

- (i) the relief of poverty;
- (ii) the advancement of education;
- (iii) the advancement of religion; and
- (iv) certain other purposes beneficial to the community as a whole.

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The governing documents of a charitable foundation (either articles of incorporation and by-laws in the case of a corporation or the trust agreement in the case of a trust) must state the objects or goals of the foundation. Those objects must fall within the above categories and must not be discriminatory in any way.

Note that a foundation has the ability to either carry on charitable activities directly itself or to provide funds to “qualified donees” (essentially, other registered charities).

No Personal Benefits

Other than reasonable salaries, no benefit from the foundation may be available or provided to its members, settlor or trustees.

No Business

A private foundation cannot carry on any business.

No Debt

A charitable foundation, whether private or public, is not permitted to incur any debt, other than debts incurred for current operating expenses, debts incurred in the course of administering charitable activities, or debts incurred in connection with the purchase and sale of investments.

In addition, in the case of a private foundation, the CRA has an administrative policy which states that a debt that is attached to an investment (such as a mortgage on real estate) will not be a permitted debt for a private foundation.

Public Disclosure

Certain information relating to registered charities is required to be made available to the public, including most of the information required to be provided by the charity in its application for registration.

Winding-Up

How and when the foundation would be wound up could be left to the discretion of the directors or trustees. The governing documents of the foundation must provide that on winding up, any remaining funds will be distributed to other registered charities.

Disbursement Quota - Generally

Like all registered charities, a charitable foundation must comply with the annual disbursement quota rules set out in the *Income Tax Act* in order to retain its registered status. The disbursement quota rules set a minimum amount that

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must be disbursed each year, to ensure that registered charities dedicate an appropriate portion of their resources to charitable purposes, as opposed to administrative or other expenses.

Generally, a private foundation is required to disburse each year an amount that is at least equal to the total of the following amounts:

- ❖ 80% of the amounts received for which it issued donation receipts in the previous year (subject to certain exceptions, as noted below), *plus*
- ❖ 3.5% of the value of its investment assets that are not used directly in charitable activities or administration. This rate is to be reviewed periodically to ensure that it continues to be appropriate.

The annual disbursement quota can be met by the foundation spending funds directly on charitable activities and/or transferring funds to other registered charities.

Excluded from the 80% portion of the disbursement quota are the following:

- a) Gifts of capital or lump sum payments received by the foundation under a Will (that is, as a bequest or inheritance);
- b) Gifts received by the foundation from registered charities; and
- c) Gifts received by the foundation that are subject to a trust or written direction from the donor that the foundation retain the property gifted (or property substituted for it) for at least 10 years.

In these cases, even though the foundation issues a receipt for the gifts, the property will not form part of the 80% portion of its disbursement quota. In addition, a gift or donation for which no receipt is issued will not form part of the 80% portion of the disbursement quota.

Because the disbursement quota rules are quite complex, professional advisors would likely need to assist with compliance.

Disbursement Quota - Initial Gift

Typically, the donor's initial gift to fund a private foundation is made subject to a direction by the donor that the foundation retains the gift, or property substituted for it, for a minimum of 10 years (or longer, if so desired). This allows the donor to get an immediate donation receipt but relieves the foundation from having to disburse 80% of the gift. However, the value of the donated property will still form part of the foundation's investment assets for the purposes of the 3.5% disbursement quota rule until the property is disbursed once the minimum holding period, as directed by the donor, has expired.

Other Administrative Requirements

As noted earlier, in order to maintain its status as a charity, a foundation must file an annual information return with the CRA. There are also rules regarding the types of investments a private foundation can (and cannot) make and penalties for non-qualified investments.

Care must be taken in the operation and administration of the foundation to ensure that its registered charitable status is not put in jeopardy.

COSTS OF A PRIVATE FOUNDATION

There are costs involved in establishing a private foundation and in its ongoing maintenance and administration.

Costs of Establishing a Private Foundation

There will generally be legal and accounting costs related to the creation, organization and registration of a private foundation. Legal costs may be about \$5,000 and accounting costs may be a similar amount. In the event that a tax-planned initial donation is intended and any special deeds of gift or transfer documents are required, there would likely be additional legal and accounting costs.

Costs of Maintaining a Private Foundation

The accounting costs relating to the ongoing maintenance of a private foundation, including the monitoring of the disbursement quota and the filing of annual information returns required under the *Income Tax Act*, may be in the range of \$2,000 to \$4,000 each year. Legal costs for ongoing maintenance of a private foundation, including the filing of corporate annual returns, may be in a slightly lower range.

Costs of Administering a Private Foundation

If desired, a family member may administer the grants or donations made by the foundation, either on a volunteer basis or for a reasonable salary. Alternatively, a professional may be hired to do so.

These costs should not deter an individual from considering a private foundation if all other circumstances suggest that it would be beneficial.

PUBLIC FOUNDATIONS

As indicated above, a designated gift to a public foundation may be considered as an alternative to creating a private foundation.

BENEFITS OF DESIGNATED GIFTS TO PUBLIC FOUNDATIONS

There are many benefits of making designated gifts to public foundations, both philanthropic and tax-related.

Philanthropic Benefits

Larger Gifts

Public foundations are registered charities, which are all tax-exempt. Therefore, the income earned on amounts donated will accumulate free from tax. This allows for a greater amount to be available for ultimate distribution to charitable causes.

Control

The use of a *designated gift* to a public foundation or registered charity allows the donor to have some control since at the time the gift is made, the donor can designate how the gift and resulting income are to be used. However, after the gift is made, control rests with the public foundation or registered charity. The donor does not have the ability to enforce the terms of the gift and has little or no recourse should the donor disagree with how the amount donated or the income earned are being used. Accordingly, the donor must trust that the public foundation or registered charity will respect his or her wishes.

If greater control over distributions is desired, a public foundation may sometimes permit a donor to establish a *donor advised fund*. With this type of fund, the donor and/or the donor's representatives can provide recommendations each year regarding distributions from the fund. This opportunity would likely only be available if there is a specified minimum amount in the fund.

Despite the reduced control, one benefit of designated gifts is that they are easier and less costly to implement and administer than the creation of a private foundation. The deed of gift required to make a designated gift to a public foundation or registered charity is also significantly less complicated and less costly than establishing a private foundation. In addition, the administration and compliance burden to fulfill the on-going reporting and operational requirements of a registered charity are borne by the public foundation or registered charity receiving the designated gift, instead of by the person who would otherwise have established a private foundation.

Privacy

Designated gifts to a public foundation or to other registered charities can provide anonymity to the same extent that private foundations can. If, however, public awareness or recognition is desired (for example, if the fund is established in memory of a person the donor wishes to publicly recognize) the public foundation or registered charity may agree to operate a sub-fund under the name that the donor wishes to be used.

Living Legacy

As with a private foundation, designated gifts can provide an individual with an opportunity to make a lasting gift for charitable purposes. However, the degree of certainty will be based on the extent to which the donor trusts the public foundation or other registered charity to respect the donor's wishes. This is not likely to be as effective as establishing a private foundation to carry out the donor's wishes.

Tax Savings

Immediate Donation Tax Credit or Deduction

As with a private foundation, the tax savings that can be achieved through the use of designated gifts arise through the charitable donation tax credit or deduction.

Designated gifts to public foundations qualify for the same donation tax credit or deduction as described above in our discussion on private foundations.

There are also additional potential tax benefits available for designated gifts to public foundations or other registered charities that are not available when using a private foundation:

- ❖ Gifts of certain qualifying securities to a registered charity (*other than a private foundation*) are given preferential capital gains tax treatment. Ordinarily, 50% of any capital gains must be included in income when disposing of capital property. This usually applies to donations of capital property as well. However, if certain investments such as mutual funds or publicly traded securities are donated to a registered charity (which includes a public foundation), only 25% of the capital gains must be included in income. As a result, there is a greater tax benefit if a donor gives securities that have increased in value *directly* to charity rather than selling the securities first and then donating the proceeds. Since this opportunity is not available for a gift of securities to a *private* foundation, this can be an important factor in favour of making a gift to a public foundation rather than establishing a private foundation.

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- ❖ The donation of shares acquired under an employee stock option benefit plan is also treated more favourably, since only 25% (versus 50%) of the amount of taxable benefits triggered on donating such property must be included in income. Similarly, only 25% of capital gains arising on qualifying ecological gifts must be included in income.

Property That Should Not Be Donated

A public foundation may not be able to accept a designated gift if the gift would result in the public foundation being offside restrictions set out in the *Income Tax Act* regarding the maximum amount of capital that can be contributed by one person or group of persons not dealing at arm's length with the foundation.

Also, the limitations described above on the availability of tax credits related to gifts of shares and debt obligations may apply. However, an exemption from these limitations may be available for gifts of shares to a registered charity (other than a private foundation) where the donor deals at arm's length with the charity and with each director, trustee, officer, and like official of the charity.

REQUIREMENTS OF DESIGNATED GIFTS

If, instead of creating a private foundation, a designated gift is to be made to a public foundation, the gift must meet the following criteria in order for the foundation to hold the gift as a sub-fund:

- ❖ The gift must be evidenced in writing;
- ❖ The donor must execute the document evidencing the gift. This document may sometimes be referred to as a "deed of gift";
- ❖ The document must clearly identify the registered charity receiving the gift (the "donee"), including its official name and registration number;
- ❖ The document must also state:
 - the amount of the gift;
 - the date of the gift;
 - the name and address of the donor; and
 - the serial number of the official receipt issued to the donor for the gift;
- ❖ Although not a requirement, it would generally be advisable for the deed of gift to specify a holding period of at least 10 years, in order to defer the disbursement requirements noted earlier. Accordingly, the document could

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specify that the property should be held, for example, for 10 years, or for perpetuity, or for a specific period greater than 10 years; and

- ❖ The deed of gift should also specify what, if any, restrictions the donor may wish to have apply with respect to the use of the gift after the holding period.

The deed of gift document should be prepared in consultation with professional advisors and with the public foundation.

CONCLUSION

A charitable foundation can be a very effective vehicle for fulfilling an individual's charitable objectives.

Given the numerous considerations that should be taken into account when deciding whether to establish and operate a private foundation or whether the charitable giving should be achieved through an existing public foundation, it is advisable to consult with professional legal and accounting advisors who are knowledgeable and experienced in this area.