

SPEEDING UP SPENDING:

COMPARING FOUNDATION MINIMUM DISTRIBUTION IN THE US, CANADA, & UK

ALANA PETRASKE AND DANIEL FRAJMAN

With income inequality and public criticism of philanthropy on the rise, interest in the speed at which philanthropic assets reach beneficiaries has grown. Prescriptive minimum distribution requirements are the subject of legislative proposals in the United States and Canada, while the United Kingdom prefers to “nudge” charities toward “revitalization.”

Charitable giving incentives and the tax reliefs enjoyed by nonprofit institutions form an important part of tax policy in the Anglo-North American world. Privileged tax treatment is subject to regulatory control to ensure that philanthropic wealth is duly deployed to charitable purposes and is not unreasonably accumulated.

The speed at which contributed assets reach beneficiaries is currently a matter of growing interest due to the increasing global income inequality, and public criticism of philanthropy and giving structures has also grown. In the United States and Canada, minimum distribution requirements are prescriptive, with a specified amount required to be applied. A change to foundation spending requirements is in early consultative and legislative stages in both jurisdictions. In contrast, the United Kingdom takes a more principle-based approach and merely requires organizations to operate for the public benefit. While no proposal for minimum spending is under consideration in the United Kingdom, a revitalization program has been introduced to “nudge” distributions out of otherwise dormant charities.

ALANA PETRASKE is a partner in the global Charities and Philanthropy team at Withers Bergman LLP in New York, and an English solicitor. She may be reached at Alana.Petraske@withersworldwide.com. DANIEL FRAJMAN, TEP, is a Partner in the Charities/Trusts and Commercial Teams at Spiegel Sohmer Attorneys, Montreal, Canada. He may be reached at dfrajman@spiegelsohmer.com.

We discuss the three jurisdictions in the following sections. We identify a shared concern about speed of spending, but each jurisdiction ultimately has very different approaches to philanthropic accumulation.

United States

While the calculation is complex, the effect is simple: U.S. private non-operating foundations are effectively required to distribute at least five percent of their investment assets each year.¹

When calculating this minimum distribution, a foundation is not limited to its charitable grants; it can also include administrative expenses, grants carried over from previous years and tax payments. For major projects, it is possible to set aside amounts for up to 60 months if IRS requirements are met. While these elements provide some measure of flexibility, consequences of noncompliance are serious. A foundation will be subject to a 30 percent excise tax on the undistributed amounts, and an additional 100 percent tax applies if the foundation is notified and still fails to correct the deficiency within 90 days.² Overall, a fairly complex architecture is required to provide for calculation, some moderate flexibility, and enforcement.

The U.S. minimum distribution requirement applicable to private foundations was introduced

over 50 years ago in the Tax Reform Act of 1969 (the “TRA”).³ Within the TRA’s broad anti-abuse purpose, this requirement is normative – to ensure foundations funded with tax-relieved contributions (and often controlled by donors) provide some immediate public benefit even where a foundation intends to operate in perpetuity (and would therefore have a legitimate justification for balancing the needs of present beneficiaries against anticipated future need). Accumulation of income should not be permitted until “unreasonable.” As the earlier law permitted,⁴ it should instead be required to distribute regularly to ensure the benefits of donor tax relief were not enjoyed without concomitant charitable benefit.

While a private foundation may spend more than the minimum, a 2017 study of IRS data indicated that most large foundations stayed fairly close to the five percent figure and that they tended toward consistency of payout over time.⁵ It is clear that prudent foundation budgeting and strategy takes account of the minimum distribution requirement and in many cases still attains overall growth.⁶

Donor advised funds. Donor advised funds (DAFs) are functionally similar to private non-operating foundations, at least from the philanthropist’s perspective. Both allow donors to separate the tax event (the deductible contribution) from the ultimate philanthropy (the distribution of a program of grants to causes). Both also allow the donor a measure of distance from the ultimate charitable beneficiary.

While DAFs were operational in the United States decades before the private foundation rules were introduced, they were not addressed in the TRA. Sponsoring organizations administering DAFs continued to be treated as public charities until greater regulation was introduced by the Pension Protection Act of 2006 (the “PPA”).⁷ While the PPA sought greater accountability for DAFs,⁸ it stopped short of imposing a minimum distribution requirement on them, expressly including this issue in a list of matters reserved for further study.⁹

The resulting treasury report did not recommend equalizing the treatment of DAFs and private foundations. However, the question has not gone away. Indeed, there has since been a series of legislative proposals revisiting DAF regulations and addressing minimum distribution. The most recent of these was introduced in June 2021 in the form of the Accelerating Charitable Efforts Act (the “ACE Act”).¹⁰ The ACE Act proposes sweeping changes to DAF

regulation and the minimum distribution by private foundations. The ACE Act would prevent a distribution made to a DAF by a private foundation from counting toward the latter’s annual distribution requirement unless fairly swiftly paid out to a charitable purpose. It would also seek to incentivize a

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higher rate of distribution by removing the 1.39 percent excise tax for a foundation that pays out 7 percent or more, or has a 25-year duration limit in its governing documents. In relation to DAFs themselves, the reforms are substantial and link the tax relief enjoyed to the duration of the DAF, whether for a “qualified” 15 year DAF or a “non-qualifying” DAF (in which case relief is delayed until distribution and is limited).

There is much discussion about the potential impact of this proposed legislation, as well as whether there is the political will to enact it (and the sector support). For the purposes of this article, however, it is perhaps sufficient to note that in the United States there is a long history of seeking to build a tax architecture that requires current charitable impact where tax relief is enjoyed, and current proposals are complex and seek to actively drive philanthropic behavior.

¹ IRC Section 4942.

² IRC Section 4942.

³ Tax Reform Act of 1969, PL 91–172, 12/30/1969.

⁴ “General Explanation of the Tax Reform Act of 1969.” Staff of the Joint Committee on Internal Revenue (December 3, 1970). Available at: https://www.pgdc.com/files/generalexplanati00jcs1670_bw.pdf.

⁵ Daniels, A., How Big Foundations Stay Big: An Interactive Guide to Giving Rates, *The Chronicle of Philanthropy* (March 7, 2017). Available at: https://www.philanthropy.com/article/how-big-foundations-stay-big-an-interactive-guide-to-giving-rates/?cid2=gen_login_refresh&cid=gen_sign_in.

⁶ Abichandani, D., (2020) A ‘Balancing Test’ for Foundation Spending, *Stanford Social Innovation Review*, *Stanford Social Innovation Review* February 10, 2020). Available at: https://ssir.org/articles/entry/a_balancing_test_for_foundation_spending.

⁷ Pension Protection Act (PPA), 2006, PL 109–280, 8/17/2006.

⁸ As Part 2 of PPA is titled; see also Joint Committee on Taxation, “Technical Explanation of H.R. 4, The ‘Pension Protection Act of 2006’ Joint Committee on Taxation (August 3, 2016). Available at: <https://www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/laws/pension-protection-act/technical-explanation-of-hr-4-prepared-by-the-joint-committee-on-taxation.pdf>.

⁹ Section 1226 PPA; see also IRS Notice 2007-21, 2007- 9 IRB 611, Study on Donor-Advised Funds and Supporting Organizations.

¹⁰ Accelerating Charitable Efforts (ACE) Act (1981). Available at: <https://www.congress.gov/bills/117/congress/senate-bill/1981/text>.

Canada

North of the border, the Canadian Federal Department of Finance opened a short public consultation on the issue of distribution in August 2021,¹¹ with an indication that changes may be enacted by 2022.

Currently, all Canadian charities, including both private foundations and the public foundations that administer DAFs, are required under the Canadian federal Income Tax Act¹² to meet an annual disbursement quota (the “DQ”) of 3.5 percent of their assets not used directly in charitable activities or administration. In other words, a Canadian charity generally must spend at least 3.5 percent of its endowment on charitable activities or on gifts to other Canadian charities each year.¹³ The 3.5 percent minimum presumably roughly matches reasonably expected investment returns on endowments, but there is a debate in this regard. Some charities are now arguing vocally for an increase in the DQ by pointing out that returns appear to have outpaced this figure for some years,¹⁴ while others, such as the Canadian Bar

criticism of the 2004–2010 regime was its perceived complexity as the main exception to the 80 percent component was to receive so-called “10-year gifts” from donors (i.e., gifts where the donor stipulated that the gift’s capital could not be encroached on for 10 years), and that exception was often difficult to apply.

The last major DQ reform, passed in 2010, essentially maintained the 3.5 percent DQ that persists to this day, but in a move that may have been aimed at promoting simplicity, abolished the 80 percent DQ component that was based on previous tax-receipted income.¹⁷ The Canadian government seemed to say at the time that the DQ was just one part of compliance by charities and that the government would shift its focus to other areas including the oversight of fundraising.¹⁸

As in the United States, the DQ can comprise some carried forward distributions (known as “disbursement excesses”), and there is some flexibility in relation to major projects, in that a charity may seek the consent of the regulator to accumulate income.¹⁹ Unlike in the United States, however, there is no monetary penalty (known in Canada as an intermediate sanction short of revocation of registered status) for failing to meet the DQ.²⁰ Instead, a Canadian foundation that fails to disburse sufficiently risks revocation, which the government has been reluctant to impose for such non-compliance. For example, the Canada Revenue Agency stated recently that it “seldom revokes the registration of charities solely based on failure to meet disbursement quota requirements as such an action is broadly considered disproportionate to the non-compliance involved.”²¹

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Association’s Charities and Not-for-Profit Section, maintain that interest rates have dramatically decreased in the years since the 3.5 percent figure was set and that an increase in the DQ may promote an encroachment of capital that may contravene many donor agreements and encourage a boosting of returns through imprudent investments.¹⁵

Previous reform. The DQ was introduced in Canada in 1976 and has undergone changes over the years, so there is precedent in Canada for a change to the spending requirement.¹⁶ From 2004 to 2010, all of the DQ’s components essentially began to apply to all charities, whether public or private, and had two major elements: basically a requirement that charities disburse amounts based on the previous year’s tax-receipted income (generally 80 percent of gifts receipted in the immediately preceding taxation year), and also a requirement that charities spend 3.5 percent (lowered in 2004 from 4.5 percent) of their endowment on charitable activities or intercharity gifts (with the government stating in 2004 that the 3.5 percent rate would be reviewed periodically to ensure that it continues to be representative of long-term rates of return). A major

Current focus. A major question in the Canadian consultation is whether that percentage minimum should be increased (whether temporarily to help fund the recovery from COVID-19 or more permanently). On one hand, an increase puts more funds into the hands of beneficiaries who need them. On the other hand, in a low interest rate environment, will an increase in the DQ cause undue encroachment on capital? Furthermore, how is a charity to deal with increased spending quotas if its own donors have previously stipulated limits on capital encroachment? (Presumably encroachment limitations can often be amended, but this could require time-consuming negotiations with major donors or court applications for trust or gift condition variations with uncertain prospects.)

Therefore, although some in Canada are calling for significantly increased spending rates, it is not

obvious that this will happen, with a more modest increase being a more likely possibility. The Canada Revenue Agency itself appears tentative regarding the possible increase and does ask in its *Backgrounder* on the DQ consultation whether other tools should be made available to it (such as monetary penalties or intermediate sanctions to enforce the DQ).

Canadian DAFs. Furthermore, it is notable that potential reform of spending requirements unique to DAFs is not specifically mentioned in that *Backgrounder* and does not at this stage appear to be the focus of any upcoming amendments, notwithstanding that although the public and larger private foundations administering the DAFs are subject to the 3.5 percent DQ, the individual DAFs are not subject to the DQ. It is not clear why this potential lacuna in the Canadian DAF rules has stayed largely off the radar, but it may be because the DAF, although very popular in Canada, is not a term or concept of art in Canadian charity legislation. It is rather just a gift to the DAF charity that is either unrestricted or subject to possible suggestion by the donor. Furthermore, it has been observed by some that known abuses of DAFs have not really come to light in Canada.²²

United Kingdom

Across the Atlantic, the landscape on minimum distribution could hardly be more different.

As a starting point in the United Kingdom,²³ the term “foundation” is not a term of art with any legal,

regulatory, or fiscal meaning. The term is widely used but only colloquially so; all charitable organizations, regardless of funding source or operational model, are simply charities. It follows that all charities enjoy the same tax relief and U.K. donors may obtain tax relief in identical fashion for gifts to any charity.

Those familiar with navigating the U.S. and Canadian private foundation regimes may assume from this that the United Kingdom is relatively unregulated, perhaps even bafflingly so. What is probably more accurate is that the United Kingdom takes a principles-based approach to regulation whereas the United States and Canada take a more prescriptive approach. Minimum spending is an excellent illustration of this difference in approaches.

Charities under English law are required to operate “for the public benefit,” a term that has come before the English courts and is the subject of extensive guidance. A charity that is not spending at all or is unreasonably accumulating assets is providing little or no public benefit and is therefore being run improperly by its board in breach of duty. The Charity Commission for England and Wales (a regulator distinct from the tax authority) has various regulatory powers that can be used to intervene where a charity is noncompliant. Likewise, from a U.K. tax perspective, there is no excise tax or penalty arising from spending too little. There are several factors that might explain the U.K. approach, including the relatively small number of charities in absolute terms, the unusual structure of tax relief on cash donations, the very long history of the Charity Commission, and the even longer history of charitable tax reliefs.²⁴

¹¹ “Consultation: Boosting charitable spending in our communities,” Government of Canada (August 6, 2021) (news release). Available at: <https://www.canada.ca/en/departement-finance/programmes/consultations/2021/boosting-charitable-spending-communities.html>.

¹² Income Tax Act, RSC 1985, c 1 (5th Supp.) – CanLII (the “ITA”).

¹³ “Annual spending requirement (disbursement quota),” Government of Canada. Available at: <https://www.canada.ca/en/revenue-agency/services/charities-giving/charities/operating-a-registered-charity/annual-spending-requirement-disbursement-quota.html>. See ITA 149.1(1), “disbursement quota.”

¹⁴ Increase the Grants (2021). Available at: <https://www.increasethegrants.ca/>.

¹⁵ “Increasing disbursement quota not the way to help charities,” The Canadian Bar Association (August 20, 2021). Available at: <https://www.cba.org/Our-Work/cbainfluence/Submissions/2021/August/Increasing-disbursement-quota-not-the-way-to-help-:-text=Planning%20for%20the%20future&text=Charities%20need%20to%20be%20able%20to%20invest%20their%20funds%20prudently,the%20public%20interests%20it%20serves>.

¹⁶ Drache, A., Stevens, D., and Hayhoe, R., *Charities Taxation, Policy and Practice* (Toronto: Thomson Carswell, 2021): 8–1–8–28.

¹⁷ Frajman, D., Foundations and Disbursement Quota Reform, *The Canadian Taxpayer* (Aug. 10, 2010): 123–125.

¹⁸ Indeed, the Canada Revenue Agency’s fundraising guidance issued in 2012, Fundraising by Registered Charities, CG-013, discourages the raising of funds without a reasonably foreseeable use, although

that principle may not apply per se to a private foundation that is not raising funds from the public.

¹⁹ Bourgeois, D., *The Law of Charitable and Not-for-Profit Organizations*. 5th ed. (New York: LexisNexis, 2016): 538. See ITA 149.1(8), (20) and (21).

²⁰ “Penalties and suspensions,” Government of Canada. Available at: <https://www.canada.ca/en/revenue-agency/services/charities-giving/charities/policies-guidance/penalties-suspensions.html>.

²¹ “Backgrounder for disbursement quota consultation,” Government of Canada (Aug 6, 2021). Available at: <https://www.canada.ca/en/departement-finance/programmes/consultations/2021/boosting-charitable-spending-communities/backgrounder-disbursement-quota-consultation.htm>. (the “Backgrounder”).

²² Demczur, J., “Primer on donor advised funds and current issues,” Canadian Bar Association National Charity Law Symposium (May 6, 2019).

²³ The United Kingdom is a single jurisdiction for tax purposes, but for the purposes of charity law and charity regulation, it is made up of three constituent jurisdictions: England and Wales, Scotland, and Northern Ireland. Where not otherwise specified, references to legal and regulatory matters are to England and Wales, the largest of these jurisdictions.

²⁴ These reliefs date back in one form or another to at least 1799 when the U.K. income tax was introduced, and the U.K. already had a specialized charity commission by 1853. See Valley, P., *Philanthropy: from Aristotle to Zuckerberg*, (London: Bloomsbury Publishing, 2020).

Revitalization: regulatory but no tax action. The closest the United Kingdom currently comes to a minimum spending regime can be found in the Charity Commission's "Revitalising Trusts" program. This commenced in 2018 in England with a view to moving assets from inactive or dormant charities.²⁵ The Charity Commission proactively contacts charities it considers to be ineffective, inactive, or dormant to ask them to take action within four weeks to prevent an investigation. The options given by the

percent of their income over the previous five years, while dormant trusts are those that have not spent any income over the past five years.

Increased scrutiny of philanthropy, foundations, and DAFs. Proposals to introduce a minimum payout requirement in the U.K. context have been raised periodically, with a particular flurry of interest in the initial years of austerity in wake of the Great Recession.²⁶ More recently (but pre-pandemic), the debate resurfaced with strong opposing views expressed about the need for a specific payout obligation.²⁷ The U.K. charity sector has been significantly affected by the global pandemic, and the role of philanthropic foundations in pushing grants through to frontline projects has rightly garnered some attention. However, the emphasis has been more on funder flexibility than on mandated spending, and DAFs have not attracted the same criticism.

Introducing a minimum spending requirement for English charities (or, as a matter of U.K. tax law, on all U.K. charities) would be a revolutionary change, although it is not impossible to legislate if there were political will to do so. However, this seems unlikely since there is no general acceptance that privately funded charities should be treated differently than others or that they are accumulating assets unreasonably.

Conclusion

Despite shared roots in the English Statute of Elizabeth, the regulation of philanthropic structures has proceeded quite distinctly on both sides of the Atlantic. The United States and Canada have pursued a more prescriptive approach to ensuring public benefit where charitable tax reliefs are enjoyed, while the United Kingdom relies on the public benefit principle and its regulatory nudge toward revitalization. However, all three jurisdictions have a demonstrated interest in ensuring charitable benefit that is not deferred too long, and of course all are affected by the pressures of the global pandemic, thus increasing income inequality and the relative success of foundations in the global markets in recent decades. Only time will tell if legislators will be persuaded that speeding up charitable spending is needed, and whether the United Kingdom's principles-based approach will continue to seem adequate. ■

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Commission are to transfer the charity assets to another charity (such as a community foundation), wind up the charity, or seek to change the charity's objects. In its first two years, approximately 1,800 charities were contacted, and the Charity Commission has estimated this "revitalized" £32 million (approximately \$43 million). Programs in Wales and Scotland were rolled out on the back of this result.

The program shares a focus with the U.S. and Canadian regimes on "unlocking" charity assets to help meet the current needs of the community. However, the similarities end there; a charity contacted under this program is guided gently toward rectifying its underspending, and the initiative is a regulatory intervention without a tax consequence.

This initiative does not seek to attack the ability of philanthropic foundations to grow and maintain substantial endowments nor the ability of families to continue to control assets after donation.

For these purposes, ineffective or inactive trusts are defined as those that have spent less than 30

²⁵ "Get help for your inactive or ineffective charity," Charity Commission for England and Wales (2019). Available at: <https://www.gov.uk/guidance/get-help-for-your-inactive-or-ineffective-charity>.

²⁶ Ranging from the academic to the polemical; Pharaoh, C. and Harrow, J. (2010) "Payout with an English accent: Exploring the case for a foundation 'distribution quota' in the UK," City University London (2010) (working paper); Bishop, M. and Green, M., "The five percent solution," STEP Journal (April 1, 2020). Available at: <https://www.step.org/step-journal/step-journal-april-2010/five-cent-solution>.

²⁷ "Alliance audio: Foundation payouts," Alliance Magazine (March 23, 2017). Available at: <https://www.alliancemagazine.org/analysis/alliance-audio-foundation-payouts/>.