Shaky Foundations? A Defence of Special Rules for Private Foundations

William I. Innes and Patrick J. Boyle*

ABSTRACT
In a recent publication of the C.D. Howe Institute, Professor A. Abigail Payne of the Department of Economics, McMaster University, made proposals for the regulation of charitable foundations. Those proposals are reviewed and critiqued in this article. Although the authors support some of Payne’s suggestions, overall they argue that the regulation of charities, and the impact that such regulation may have on donors and institutions, is too important to base on conjecture; solid empirical information about the past—supported by detailed study, consultation, and analysis—is necessary.

KEYWORDS: CHARITIES ■ FOUNDATIONS ■ CLASSIFICATIONS ■ PRIVATE FOUNDATIONS

CONTENTS
Introduction 740
Payne’s Thesis 740
Our Response 741
General 741
Business Activities 743
Gifts from Other Registered Charities 743
Differential Treatment of Donations 744
Gifts of Non-Qualifying Securities 744
Gifts of Marketable Securities 745
Reporting Requirements and Transparency 745
Conclusions 746

* Of Fraser Milner Casgrain LLP, Toronto.
INTRODUCTION

In a recent paper, Professor A. Abigail Payne advocates putting public foundations and private foundations on level regulatory ground. Payne argues that most of the distinctions between the two types of foundations are unnecessary and are likely to curb the growth of charitable giving through the use of private foundations. Payne believes that the introduction of greater transparency and public disclosure will largely eliminate the need to treat public and private foundations differently. In this critique, we propose to examine Payne’s premises and conclusions and respond to them from the tax practitioner’s viewpoint. Because Payne’s paper is policy-oriented and contains little technical detail, we will, to the extent possible, refrain from a technical analysis of current and historical provisions of the Income Tax Act in an effort to respond to a policy piece in kind.

PAYNE’S THESIS

In Payne’s view, only two of the current special restrictions on private foundations make sense:

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.

Payne recommends greater disclosure as the cure for potential abuses in private foundations and makes three specific recommendations:

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.

---

2 Both terms are defined in subsection 149.1(1) of the Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended. Unless otherwise stated, statutory references in this article are to the Income Tax Act.
3 Supra note 1, at 10.
4 Ibid.
In Payne’s view, greater transparency will virtually eliminate the need for distinctions between public and private foundations:

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.5

OUR RESPONSE

General

We agree with Payne’s underlying premise that ineffective restrictions and complexity serve no useful purpose in the Act. In the case of the distinctions between public and private foundations, such restrictions and complexity would be particularly invidious if they also tended to discourage philanthropy. However, we do not think that she makes a convincing case either that most of the existing restrictions are ineffective or that the existing rules serve to dampen philanthropic activity.

Payne is no doubt correct in saying that the distinction between public and private foundations is based on the unspoken assumption that there is more room for abuse in a closely controlled foundation. Although this assumption may be unsupported by empirical data, it is in line with common sense and experience, and we do not think that one can disregard it. Moreover, from the tax practitioner’s viewpoint, it is amply supported by anecdotal evidence. To give just one example, the rules in the Act that prohibit a registered charity from changing its original status (that is, as a charitable organization, public foundation, or private foundation) emerged in the 1980s because a number of private foundations took the position that if they had no receipted donations in the prior taxation year and made no charitable expenditures in the current taxation year they were in compliance with the disbursement quota rules; they had become “charitable organizations” because no portion of their income was paid in the year to a “qualified donee.” Thus, they argued that they were not subject to the 4.5 percent distribution requirement with respect to their investment assets in that year.

Time after time over the last 35 years, the Act has had to be amended to deal with what the Department of Finance and the Canada Revenue Agency have perceived as abusive practices in the charitable sector. The example cited above in connection with changing the status of a charity is simply one instance of such an amendment.

---

5 Ibid.
In fairness, however, the fact that a foundation meets the arm’s-length requirement of a public foundation is no guarantee of probity. By the same token, any individual can form a charitable organization that he or she essentially controls. That having been said, common experience—particularly in the tax profession—suggests that the public character of, and the public’s involvement with, larger foundations and charitable organizations tends to curb the worst abuses.

One of Payne’s most troubling statements is that “there is scant evidence of abuse of the tax system by private foundations.” Our difficulty with this statement is that there is scant evidence of either abuse or compliance by private foundations. We personally doubt that such evidence exists in a readily accessible form. Furthermore, to the extent that it does exist, we think it is likely that access to it by private scholars is restricted or prohibited by the confidentiality provisions of the Act. We will deal with this point further in our discussion of Payne’s advocacy of “transparency,” but we think that one of the recurring flaws in her otherwise valuable paper is the implicit assumption that it is safe to make fundamental changes to the regulation of charities under the Act in the absence of hard data.

Payne says that “donors who prefer to see their names associated with their charitable donations” are motivated to establish private foundations. Although anyone who has ever gone to a concert, an art gallery, or a hospital knows that there is no shortage of well-intentioned donors who want their names made public, in our experience the principal motivating factor behind the use of private foundations is long-term control over the investment of funds and the making of donations to other charities. There is nothing necessarily wrong with this; the desire for control is a personality trait often associated with rich and successful individuals. However, it is also highly indicative of why there is a potential for abuse in private foundations—control run amok.

Finally, Payne argues that the emergence of “donor-advised gifts” makes the distinction between private foundations and other charities less supportable. In our view, this argument is simply wrong. It is difficult to ascertain precisely what Payne intends by “donor-advised gifts.” Today, one usually hears this term in connection with community foundations; a donor can make a donation of funds to a community foundation that will be administered and invested in a centralized fashion with other funds. Disbursements are made in consultation with the donor. The degree of donor participation varies from gift to gift, but community foundations are not mere cat’s-paws doing the will of donors. Community foundations are, and should be, organizations with a high degree of public involvement and institutional transparency. They have high ethical standards and do not simply serve to facilitate the tax-planning schemes of unscrupulous donors.

Other forms of donations with strings attached can vary from testamentary endowments to gifts in trust. Any tax practitioner knows that dealing with the level of

---

6 Supra note 1, at 2.
7 Ibid., at 3.
control involved in such gifts is a precarious thing. Too much control, or inappro-
priate controls, may deprive the transaction of its character as a “gift,” thereby
depriving the donor of any tax benefit. Moreover, most established charities have
well-defined policies in respect of the limitations and controls they will accept, and
particularly what types of investment arrangements they will accept in connection
with donations.

**Business Activities**

Charitable organizations and public foundations are allowed to engage in related
business activities. Activities in which all or substantially all of the workers are unpaid
are, by definition, related business activities. What other activities are permissible
is at present lost in a fog of rather difficult case law. The Act prohibits private
foundations from engaging in any form of business activity. Payne thinks that this
blanket restriction should be removed, although “some types of business activities,”
which are left unspecified, should stay prohibited.

Although the origins of these rules are far from clear, the central premise seems
to be that charities should not be permitted to compete with private-sector busi-
nesses by using tax-subsidized capital. The related-business exception seems to
contemplate purely volunteer operations as well as an ill-defined category of activity
that arises out of, or is incidental to, the charity’s main charitable activities or goals.

We agree with Payne’s statement that there seems to be no logical reason why a
private foundation should be prohibited from carrying on a “volunteer” business
activity. It is difficult to imagine how a volunteer-run business could be used to
facilitate some form of aggressive tax planning on the part of the foundation’s
controlling donor. Such activities, by their general nature, tend to have the hall-
mark of probity.

We are not, however, prepared to go further than this without solid empirical
research. Payne’s conclusion that “some types of business activities” should not be
permitted illustrates the difficulty of settling on a workable solution. As well, the
confusing state of the law in connection with business activities carried on by other
charities suggests that any other significant change to the restrictions on private
foundations is not likely at this time.

**Gifts from Other Registered Charities**

Private foundations must disburse 100 percent of the prior year’s donations from
other registered charities (except specified gifts), while public foundations and chari-
table organizations must distribute only 80 percent of such amounts. Payne writes:
“Again, the reason for this special treatment of private foundations is not clear.”

---

8 See the definition of “related business” in subsection 149.1(1).
9 Although, knowing the imaginative ability of tax practitioners, perhaps not impossible.
10 Supra note 1, at 7.
The purpose of the 100 percent rule is to prevent the use of a series of related private foundations to reduce a private foundation’s disbursement requirements. Assume, for example, that the Smith family established the Louise Smith Foundation and the Doug Smith Foundation. In year 1, the Louise Smith Foundation had a $1,000 disbursement quota. If it donated $1,000 to the Doug Smith Foundation, it would meet that quota. In year 2 (if the 80 percent rule applied), the Doug Smith Foundation could meet its disbursement quota by donating $800 to the Louise Smith Foundation. In year 3 (if the 80 percent rule applied), the Louise Smith Foundation could meet its disbursement quota by donating $640 to the Doug Smith Foundation, and so on.

**Differential Treatment of Donations**

Payne’s argument that all donations to registered charities should be treated equally, regardless of the recipient charity’s classification, has a superficial attraction. However, it breaks down under scrutiny. The applicable underlying policy can dictate that the same gift be treated differently in the hands of different charities. Gifts of cultural property, for example, receive favoured treatment if they are made to “designated institutions.” Gifts of that same cultural property to any other qualified donee are treated in the same way as any other donation in kind. The Act has historically contained various distinctions of this sort.

**Gifts of Non-Qualifying Securities**

The rules respecting gifts of non-qualifying securities are a relatively recent, and probably long overdue, addition to the Act. Although their operation is somewhat complex, their purpose is not. It is highly problematic to provide tax credits or deductions for gifts of illiquid, hard-to-value property such as shares, obligations, and debts that are not publicly traded. The simplest and likely the most accurate approach is to value the gift, and award the deduction or credit, when the charity disposes of the property and receives liquid proceeds.

The rules make an exception for gifts of non-qualifying securities that are shares. If the shares meet certain arm’s-length conditions, public foundations and charitable organizations may issue immediate receipts to donors. This exception does not extend to private foundations. In the case of any other form of non-qualifying security (shares that do not meet the arm’s-length conditions, debts, etc.), the rules apply equally to all registered charities. One might argue that such a prohibition is unfair because the private foundations could ultimately sell the securities, realize liquid proceeds, and issue a donation receipt. The difficulty with this argument is that it feeds directly into the overriding concern about private foundations being too rigidly controlled by their founding donors. A donor could use the securities for some other financial advantage prior to liquidation—for example, to prop up the financial position of a failing corporation. We are not suggesting that the door should be closed on this proposal; rather, we believe that more empirical evidence and analysis are necessary before such a change can or should be made.
Gifts of Marketable Securities

Gifts of marketable securities are, to some degree, the flip side of gifts of non-qualifying securities. They constitute gifts of liquid assets that are easy to value. The issue here, however, is not one of prohibiting deductions but one of affording incentives to donors. When such gifts are made to charitable organizations and public foundations, the donor’s inherent capital gain is reduced by 50 percent. That is not the case when identical property is donated to private foundations. One of us has previously written in the Canadian Tax Journal that this incentive should be increased to a 100 percent reduction of the inherent capital gain and extended to private foundations.¹¹ On this point, we agree with Payne. There seems to be no obvious reason why extending this provision to private foundations would impair any specific policy objective of the Act. Moreover, Payne may be right in saying that the failure to extend this provision to private foundations will result in the loss of donations that otherwise would have been made to private foundations.

Reporting Requirements and Transparency

In a perfect world, Payne’s increased reporting requirements and institutional transparency might work. In practice, her recommendations present a number of difficulties:

1. It is difficult to develop balanced reporting requirements that are workable and effective. The public (and private) disclosure requirements for charities under the Act have grown increasingly complex and lengthy over the years, but they are still likely not adequate for the purposes that Payne contemplates.
2. Increased reporting results in increased compliance costs for all charities, most of which are not affected by the concerns Payne raises in her paper.
3. Increased reporting can result in undue intrusion into personal and institutional privacy. In what circumstances, for example, should the financial positions of individuals be disclosed, and to what end?
4. The types of abuse to which private foundations may be subject are elusive and ever-changing. Put simply, tax professionals and donors will be constantly looking for ways of legally avoiding reporting compliance.
5. Finally, and perhaps most importantly, disclosure requirements have no effect when there is an intent to deceive.

A key point is that private foundations are rarely audited. With roughly 50 years of tax practice between us, we have seen only three audits of private foundations; two of them were in a tax-shelter context. If we are to have more empirical data on the issues that Payne raises, we simply need more field audit experience.

CONCLUSIONS

Payne’s paper is a valuable contribution to the debate about private foundations. Her proposal to allow private foundations to engage in volunteer businesses and to issue tax-advantaged receipts for gifts of marketable securities has merit; the rest of her proposals, however, require a considerable amount of further study and research. We agree with her notion of expanding reporting requirements and institutional transparency so long as this can be done without undue compliance costs and invasion of privacy. However, we do not think that the advent of such new procedures should result in an immediate change in the rules governing private foundations. Rather, the new requirements should be studied for a period of time—perhaps five years—to determine whether empirical data support a change in the rules. This research should be combined with an expansion of field audits of private foundations to check the accuracy of the new disclosure material and to look for weaknesses in that material.

Until such steps are taken, Payne’s recommendation will remain based on conjecture—a shaky foundation for the regulation of such an important part of the charitable sector.