

Brief (summary) submitted to the
Standing Committee on Finance of the
House of Commons of Canada

Respecting the study: Tax Incentives for Charitable Donations

By Brigitte Alepin¹
February 7, 2012

Private charitable foundations²

The number of private charitable foundations has been increasing exponentially in North America. At the time the Rockefeller Foundation was created in 1913, there were only a few private foundations in United States; in 1998 there were 70,480; and in 2011, more than 120,000.³ In Canada, as of December 2010, there were 4937 private charitable foundations with a value totalising 20 billion dollars.⁴

Charity is important. However, the tax system needs to have an appropriate approach to charity—unlike the approach it has now to private foundations. The tax rules related directly and incidentally to private foundations are not fair to taxpayers in general and not effective for public finances.

The Laws Governing Private Foundations

In Canada, as in most other countries, governments encourage the private practice of charity and philanthropy through tax incentives. In 2012, Canadian taxpayers may deduct up to 50 per cent (federal and provincial) of the amount of donations made to charities from the tax they owe the government. Donations of certain assets (such as shares of certain qualified corporations) are even more advantageous because they are exempt from taxation on capital gains, normally applicable at the point of sale.

There are three types of charitable organizations: public foundations, private foundations and charities. Charities are distinguished from the others by their active orientation. Generally, charities must devote all their resources to the charitable activities that they conduct themselves. Foundations fund charitable activities conducted by other organizations.

The difference between public foundations and private foundations lies in the nature of their control. A private foundation is controlled by a single donor or one family through a board of directors at least 50 per cent of whom are tied to the donor or the family. In contrast, a public foundation is governed by a board composed of a majority of unrelated directors and usually receives its funding from multiple donors with no links between them.

“Registered” charities enjoy two privileges: they do not pay taxes, and they can issue official receipts that allow donors to receive tax credits. The rules that charities must follow are found primarily in the tax code. They regulate the investments, business activities, political activities, loans, grants and international activities and “disbursement quota” under which they must spend a minimum amount annually for charitable purposes.

The problems

In this document, only the most significant problems the tax system creates for private foundations will be addressed.⁵ Arguments illustrated using examples from abroad also apply to Canada.

Problem #1: the threat to democracy

The current rules governing private foundations bypass the political system because they allow founders to appropriate a piece of public power, which in a democracy should be granted only to the people or to individuals elected by the people.

As early as 1789, Thomas Jefferson, later the third president of the United States, identified the problem: “Private fortunes should be dissolved by the abolition of the law of primogeniture and of their unalienable character. Otherwise, a few individuals and institutions could raise with time enough wealth to govern ordinary citizens.”

In 1915, two years after the creation of the Rockefeller Foundation, the U.S. Congress felt the need to investigate the activities of large foundations. The commission established for this purpose concluded,

The domination by the men in whose hands the final control of a large part of American industry rests is not limited to their employees, but is rapidly being extended to control the education and social survival of the nation. This control is being extended largely through the creation of enormous privately managed funds for indefinite purposes, hereafter designated “foundations.”⁶

In the early 1950s, the U.S. Congress once again became interested in the activities of private foundations. The Reece Committee concluded that the power granted to private foundations posed a threat to democratic government. The committee noted that some of the largest foundations had actively supported attacks on the social and governmental system of the United States and had financed the promotion of socialism and collectivist ideas. The committee proposed that the law be amended to impose a time limit on each foundation’s existence.⁷

The way our system gives power to a minority of unelected taxpayers is best illustrated by the Giving Pledge initiative. Through this initiative, a small group of billionaires will have access to \$600 billion—more than half of which represents tax savings provided by governments—that they can use to act on public policy questions, as they see fit. These billionaires seem to be good people, but why should societies agree to give up democratic control in this way? The democratic system is a hard-won achievement of the last few centuries, and the Arab Spring demonstrates that it remains a compelling cause in our own time.

In Quebec, this question of control has been raised in regard of the public-private philanthropic partnerships or “PPPP” between the Chagnon Foundation (and the Chagnon family) and the Quebec government on projects mobilizing resources over \$1 billion on ten years.

The rules applicable to private foundations also allow power to be exercised undemocratically and it also appears that the people who run and administer private foundations do not reflect the racial and cultural diversity of the communities they serve.⁸ In 2006, a survey of 802 private foundations revealed that only 23.2 per cent of employees and 13 per cent of directors in the United States belonged to a racial group other than white, compared to the national average of 33.8 per cent.⁹

Apart from the obligation to provide grants to recipients that meet qualifications set by tax authorities, foundations have total freedom to choose in which projects they will invest. This arrangement can therefore help one group of recipient organizations at the expense of others.

According to that same study of 802 private foundations conducted in 2006, only 7.4 per cent of total grant dollars were distributed to minority/ethnic communities.¹⁰

Problem #2 : Disbursement Quota

According to Canadian tax laws, private foundations must spend a minimum amount each year on charitable activities. The percentage required is called the disbursement quota and since March 2010 the disbursement quota for private foundations has been set at 3.5 per cent. So every year, private charitable foundations must spend on charitable activities, or give to qualified recipients, an amount equal to or greater than 3.5 per cent of their capital.¹¹

There was a time in Canada when the disbursement quota payment imposed on charitable foundations was substantially higher.¹² The reduction in the disbursement quota allows Canadian foundations keep their startup capital and rest assured that their foundations will last indefinitely. They argue that the charitable impact will be greater in the long term if private foundations preserve their capital and distribute only the returns. But not everyone agrees with this way of thinking, especially in recessionary times.

Some feel that foundations established to meet genuine priorities of today will not necessarily meet the needs of future generations. The Helmsley private foundation is often used as an example to illustrate this point: \$8 billion, mostly founded by taxpayers money, in a perpetual foundation for the maintenance and welfare of dogs.

Besides, is it really necessary to keep capital for the future? After all, new billionaires and their foundations will arise and new wealth will enter the philanthropic stage, so it is not necessary to preserve the initial capital in perpetuity.

Several major philanthropists oppose the idea that foundations should be perpetual, arguing that wealth should be spent during the person's lifetime. Julius Rosenwald, who established the Julius Rosenwald Fund in 1917, wrote,

I am not in sympathy with perpetuating endowment and believe that more good can be accomplished by expending funds as trustees find opportunities for constructive work than by storing a large sum of money for long periods of time. By adopting the policy of using the fund within this generation, we may avoid these tendencies toward bureaucracy and a formal or perfunctory attitude toward the work which almost invariably develops in organisations which prolong their existences indefinitely. Coming generations can be relied upon to provide for their own needs as they arise.

Chuck Feeney, a billionaire Irish-American philanthropist, argues that people should give while they are alive. His philosophy is largely influenced by Andrew Carnegie's "Gospel of Wealth," which expressed the view "that people of substantial wealth potentially create problems for future generations unless they themselves accept responsibility to use their wealth during their lifetime to help worthwhile causes."

The permanence of foundations also calls into question the nature of the original gift. When a founder creates a private foundation and transfers his or her wealth into it, is it logical that the founder should receive a tax receipt for the amount transferred to the foundation, considering that, ultimately, this capital will never be spent for charitable purposes? For example, if Mr. X, a Canadian resident, donates \$100 million to his foundation in 2012, which will never be spent for charitable purposes, is it logical for the tax system to grant him a saving of \$50 million? In this example, the founder enjoys a tax saving of \$50 million in year one, and only \$3.5 million will be

invested by the private foundation for charitable purposes in society each year. Thus, it could take up twenty years to replenish the public coffers.

Finally, it is puzzling that the transfer should qualify as a gift for legal purposes, especially when we know that the amounts that represent the capital of the donations are almost never spent for charitable purposes. A gift implies that the donor divests himself or herself irrevocably of the property in question in favour of another person, without compensation and with a generous spirit. Canadian tax laws contain several specific anti-avoidance rules that prevent taxpayers from accruing a tax advantage by simulating gifts to themselves or related persons.

Most important Recommendation¹³: Increase the disbursement quota to 8 per cent

While issues relating to private charitable foundations have not really been raised in Canada, the situation seems to be different in the United States. New York State passed a new law in August 2010 limiting tax deductions for people earning more than \$10 million. In his budget for fiscal year 2012, President Obama proposed that taxpayers in the highest tax bracket be able to deduct charitable donations to a maximum rate of 30 per cent, down from 39.6 per cent in 2011. This is not a new idea. He had made similar proposals in 2009 and 2010.

In fact, the fundamental problem with private charitable foundations is that they are allowed to exist indefinitely. To correct this situation and to reduce the hole in public finances, an increase in the disbursement quota of 3.5 per cent in Canada (and 5 per cent in the U.S.) to 8 per cent should be considered. This would be a simple solution that would not interfere with the tax break donors receive on donations. As long as the rate of return remains below 3 per cent, a disbursement quota of 8 per cent will require the distribution of the foundation's capital over a fifteen-year period. This would also represent a more acceptable time frame to the taxpayers who funded the creation of these foundations.

As of 2012, the frozen assets held by private foundations in Canada are worth more than \$20 billion. If the disbursement quota were increased from 3.5 per cent to 8 per cent, an additional \$1 billion of these funds would be released, annually.

Finally, it should be mentioned that at its 2011 annual conference,¹⁴ the Council on Foundations, an organization of American foundations that provides services and support to its members, put philanthropy "on trial."¹⁵ The question was whether private foundations fulfill their mission to serve the public good.

The prosecution painted a damning picture of philanthropy and criticized the tax benefits available to private foundations. It said that while we've come to expect lobbyists to argue for tax breaks for their clients, the American people have real needs such as guaranteed health care and no more tax breaks for the rich. For its part, the defence described the importance of philanthropy and the charitable sector. It argued that even if it is not perfect, the sector continues to pursue the common good.

In the end, ten of twelve jurors found the accused guilty!

¹ Brigitte Alepin - *Public finance and tax policy expert* - www.brigittealepin.com

A certified accountant, Brigitte Alepin is a Harvard graduate and holds Master's degrees in taxation and public administration (with a major in microeconomics).

² Several sections of this brief are taken from the book, *Bill Gates, pay your fair share of taxes...just like we do*, by Brigitte Alepin, March 2012.

³ National Center for Charitable Statistics (NCCS), "Number of Private Foundations in the United States, 2010"

⁴ Canada Revenue Agency, Charities Directorate.

⁵ Other problems exist: Per examples:

- In the world of charity—and especially in the world of private foundations—there appears to be more tolerance than elsewhere for serious misconduct and unreasonable expenses, and senior management faces no real accountability and does not fear competition. The Auditor General of Canada's report released in the fall of 2010 noted that the CRA does not have sufficiently detailed internal guidance to support the application of sanctions.⁵ The report revealed that between April 2006 and March 2009 the CRA continued to use letters of awareness, compliance agreements and revocation of charitable status to enforce the law, while it rarely imposed intermediate sanctions. In fact, there were 127 revocations for cause and only two sanctions other than revocation.
- Canada Revenue Agency does not exercise tight enough supervision and is not transparent in carrying out its duties related to charities. The Revenue Canada Agency has approximately 41,000 employees. Of those employees, the Charities Directorate has 270 employees at headquarters in Ottawa, and there are also 40 field auditors that carry out charity audits across Canada (2010 Fall Report of the Auditor General of Canada). Canada's 85,000 charitable organizations, issuing 13.9 billion dollars in tax receipts, are therefore monitored by only forty field auditors.

According to the OECD's 2009 *Report on Abuse of Charities for Money-Laundering and Tax Evasion*, based on information provided to the organization by nineteen countries in 2008, Canada could expect to lose \$200 million annually in taxes through fraud linked to the charitable sector.

⁶ Our Dying Republic: The cause and the cure; Jr George Dunlap Burns; Xulon Press, 2011, citation on page 182

⁷ The news is full of examples showing how the legal framework for private foundations allows financial power to reign supreme. In an article published in the *Huffington Post* in 2006 ("The Gates and Buffett Foundation Shell Game," August 22, 2006, www.huffingtonpost.com/sheldon-drobny/the-gates-and-buffett-fou_b_27780.html), Sheldon Drobny explained, "My background is finance and accounting. I started my career in 1967 with the IRS as a specialist in taxation covering many areas of the tax law including the so-called legal loopholes to charitable giving ... The Gates foundation will be in the long run richer than the Catholic Church, which has accumulated wealth and power for over 1500 years ... The Gates Foundation and the Catholic Church have the same goals. They are to keep the legacies for which they were created. For Bill Gates and Warren Buffett it is the control and legacy of family wealth as in the ancient days of the Pharos of Egypt. And by not paying any taxes, Gates will be more powerful than the Pope." See also the British Ministry of Defence document *Global Strategic Trends — Out to 2040* (www.mod.uk/NR/rdonlyres/38651ACB-D9A9-4494-98AA-1C86433BB673/0/gst4_update9_Feb10.pdf), which signals "the emergence of a global elite, a powerful network of individuals and institutions that sits above the level of individual states and influences the global agenda." The document questions whether it is wise to place so much power in the hands of undemocratic institutions. And in *The Molecular Vision of Life: Caltech, the Rockefeller Foundation, and the Rise of the New Biology* (New York: Oxford University Press, 1993), Lily E. Kay wrote, "Their numerous projects and the unprecedented scope of their financial and institutional resources shaped the development of culture and the production of knowledge in the United States. Through education, public opinion, stimulation of specific research agenda, and the promotion of selective categories of knowledge and research, the Foundation played a key role in the creation of a hegemonic bloc."

⁸ Joel L. Fleishman, *The Foundation: A Great American Secret: How Private Wealth is Changing the World* (New York: Public Affairs, 2007).

⁹ Cristina Maldonado, "The Race Gap," *Contribute: The People and Ideas of Giving*, retrieved from www.contributemedia.com/trends_details.php?id=201

¹⁰ Ibid.

¹¹ In more technical terms, 3.5 per cent of all of the organization's assets not directly used in charitable activities or administration, if these assets exceed \$25,000.

¹² Before March 2010, there were additional requirements placed on both public and private charitable foundations, beyond the general minimum of 3.5 per cent. Public foundations also had to spend an amount equal to 80 per cent of the previous year's tax-receipted donations and funds received from other charities. Private foundations had to spend 100 per cent of these amounts. Before March 2004, the general minimum was 4.5 per cent, not 3.5 per cent.

¹³ Other recommendations exist. See *Bill Gates, pay your fair share of taxes...just like we do* for more details.

¹⁴ "Philanthropy on Trial," Council on Foundations *Windows*, retrieved from www.cof.org/events/conferences/2011Annual/trial.cfm

¹⁵ Gara LaMarche, president and CEO of The Atlantic Philanthropies, was the prosecutor; Ralph R. Smith, executive vice-president of the Annie E. Casey Foundation and former board chair of the Council on Foundations, was the defence counsel; and retired Pennsylvania Supreme Court Justice Jane Cutler Greenspan acted as the judge.