The tax regime for private charitable foundations—a threat to democracy and an infringement on government finances

In 2014, there were 5,315 private charitable foundations in Canada, with assets totalling approximately $25 billion.1 Charity is important. However, the tax regime must approach it from the proper angle—one that is different from the one that currently applies to private foundations.

The problems

This document will address only the most important problems with the tax regime for private foundations. The comments, which are illustrated using examples from abroad, are also applicable to Canada.

The 3.5% disbursement quota is an infringement on government finances

According to Canadian and Quebec tax laws, private foundations must spend a minimum amount each year on charitable activities. The percentage required is called the disbursement quota. This quota is currently set at 3.5%. Every year, private charitable foundations are required to spend an amount equal to or greater than 3.5% of their capital on charitable activities or give to qualified organizations.

There was a time in Canada when the disbursement quota rate imposed on charitable foundations was substantially higher. According to Finance Canada’s 2004 budget, “analysis indicates that the current 4.5% disbursement quota rate is high relative to long-term investment returns. Accordingly, the budget proposes to reduce the 4.5% disbursement quota rate on capital assets to 3.5%. This rate will be reviewed periodically to ensure that it continues to be representative of long-term rates of return.” The reduction in the disbursement quota rate allows Canadian foundations to keep their start-up capital and ensure that their foundations will last indefinitely.

Several Canadian private charitable foundations are perpetual. For example, the Fondation Lucie et André Chagnon was established in 2000 with $1.4 billion in start-up capital; in 2013, the foundation’s assets totalled $1.64 billion.

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.

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 if this capital is never spent for charitable purposes? For example, if Mr. X, a Quebec resident, donates $100 million to his foundation in 2014—an amount that will never be spent for charitable purposes—is it logical for the tax system to grant him a saving of $50 million? In the example in Figure 1, it could take 25 to 30 years, if not perpetuity, to replenish the coffers of the Quebec society.

### Figure 1: The “deal” between private charitable foundations and Canadian taxpayers
e.g., $100,000,000 donation

<table>
<thead>
<tr>
<th>Founder</th>
<th>Foundation</th>
<th>Canadian taxpayers</th>
</tr>
</thead>
<tbody>
<tr>
<td>$50,000,000</td>
<td>Non-taxable annual income $5,000,000 (hyp.)</td>
<td>$3,500,000 spent on charity each year (3.5%)</td>
</tr>
</tbody>
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25-30 years before public accounts balance in favour of taxpayers

A threat to democracy

The current rules governing private foundations circumvent the political system by allowing 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.

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.”

The Bill & Melinda Gates Foundation illustrates how the tax regime empowers a minority of non-elected taxpayers. In 2013, the Bill & Melinda Gates Foundation had access to net assets totalling $36 billion—more than half of this amount representing tax breaks from governments—with which to intervene at its discretion in matters of public policy. In comparison, the World Health Organization had net assets of $1.5 billion at that time.
In Quebec, this question of control has been raised in relation to the public-private philanthropic partnerships or “PPPPs” between the Chagnon Foundation (and the Chagnon family) and the Quebec government on projects mobilizing resources in excess of $1 billion over a ten-year period.

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 time.

**Main recommendation: Increase the disbursement quota**

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 government finances, an increase in the disbursement quota rate of 3.5% in Canada (and 5% in the U.S.) is 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%, a disbursement quota rate of 8% will require the distribution of the foundation’s capital over a 15-year period. This would also represent a more acceptable time frame for the taxpayers who funded the creation of these foundations.

As of 2014, the frozen assets held by private foundations in Canada are worth more than $25 billion. If the disbursement quota rate were increased, a significant portion of these funds would be released, to Quebec society.

**International tax competitiveness – Proposal: 2015 TAXCoop conference**

Without a doubt One of the best initiatives coming out of Canada to help create tax regimes that are more effective and better adapted to the 21st century is TAXCoop.

The goal of TAXCoop is to help governments reflect on the issue of tax competitiveness and the race to the bottom, and to take action to reach the consensus needed to implement solutions. The first TAXCoop will take place in Montreal in 2015, at a strategic time when the Canadian and international tax regimes are a hot topic and the solutions proposed by the OECD will be the subject of negotiation.

TAXCoop is particularly timely because the governments in Canada are proposing to rebalance the budget by means of a financial plan based almost exclusively on spending cuts, while a substantial portion of government-finance problems are the result of gradual reduction of taxes on mobile capital and intangible assets. It is easy to understand why governments would choose this approach in the context of international tax competitiveness. However, to support the proposed initiative to distribute the tax burden between those taxpayers who reap the greatest benefits from gaps in the current system and others, we urge the federal government to support the first TAXCoop conference that will take place in Montreal in 2015. This will show the taxpayers who will inevitably bear the brunt of the shortfall will see that Canada is showing real leadership by moving tax regimes into the 21st century and ensuring fair taxation of income.

To rebalance government finances and to increase the efficiency and impartiality of the tax regime, a solution to the tax competitiveness problem—which has become destructive among countries because it results in significant tax leakage—must be found. According to Christine Lagarde, Managing Director of the International Monetary Fund (IMF), “there would be more revenue for all if countries resisted the temptation to compete with each other on taxes to attract business. By definition, a race to the bottom leaves everybody at the bottom.” The statutory corporate income tax rates in OECD member countries dropped on average from 32.6%
in 2000 to 25.3% in 2014. This downward trend is likely to continue because, in several jurisdictions, tax competitiveness is the active force behind the recovery. This trend is already quite evident with respect to mobile capital and multinationals, even though effective rates are plummeting.

According to some experts, we can expect to see total tax exemption in favour of mobile capital within the next 10 to 20 years, confirming the limited life span of tax breaks to attract capital. (Thomas Piketty, The American Enterprise Institute for Public Policy Research). At that rate, the tipping point is coming soon, hence the need to immediately develop initiatives to counter the trap of extreme tax competitiveness among countries. Several industrialized countries, especially Ireland, the United Kingdom and Luxembourg, allowed themselves to be tempted by international tax competitiveness.

Canada has also shown that it a major tax competitor. Together with Ireland, the Netherlands, Bermuda and the Cayman Islands, it is a key destination for tax inversions. Moreover, like Ireland and the Netherlands, which attract capital with the Double Irish and Dutch Sandwich techniques, Canada, gives foreign multinationals a “Canadian Club” that is a combination of tax inversions, transfers of taxable income to tax havens with which Canada has signed a tax information exchange agreement and generous domestic tax regimes.

The goal of the OECD’s Base Erosion and Profit Shifting (BEPS) project is to identify specific solutions to help jurisdictions counter the tax optimization strategies used by multinationals to take advantage of loopholes in the current system to artificially shift profits to low-tax jurisdictions. If the States agree to implement a BEPS action plan, it will be a first step towards corporate taxation in the era of globalization. TAXCoop will be take another step that speaks directly to the problem of tax competition among countries and the dynamics of the race to the bottom and that would help OECD reach the consensus needed to implement solutions.

TAXCoop organizing committee: Daniel McMahon, FCPA, FCA, president; Brigitte Alepin, MPA, M.Fisc., CPA, CA, project originator; Lyne Latulippe, Ph.D., M.Fisc.; Stéphane Pallage, Ph.D., MS; Natalie St-Pierre, B.Comm.


3 There are other recommendations. For more information, see Bill Gates, pay your fair share of taxes...just like we do.