Fundraising guidance poses challenges for charities

TERRANCE CARTER

> The primary focus of the guidance is the determination of a ratio of fundraising expenses to fundraising revenue calculated on an annual basis.

In June, the Charities Directorate of the Canada Revenue Agency (CRA) released its much-anticipated guidance, "Fundraising by Registered Charities," which applies to fundraising activities by all registered charities. The guidance had been in refinement for over a year following a consultation period with the charitable sector. While the guidance represents a marked improvement over an earlier draft, compliance will likely still prove challenging for most charities.

At the outset, the guidance (CPS-028) explains that if a fundraising activity is appended to another activity that is directed at achieving a charitable purpose, the charity may, in certain specified situations, allocate the costs between fundraising and charitable expenditures. The guidance goes on to explain, however, that in addition to having to comply with its terms, charities must also meet all other requirements of the *Income Tax Act*, such as its annual disbursement quota.

The guidance outlines four types of prohibited conduct related to fundraising, including fundraising that: (a) is illegal or contrary to public policy; (b) is a main purpose of the charity (since fundraising is not a charitable purpose in and of itself) or an independent purpose; (c) results in more than an incidental or proportionate private benefit to individuals or corporations; and (d) is misleading or deceptive.

A registered charity must report all fundraising expenditures in its T3010B annual information return. However, an activity does not have to be included as a fundraising expenditure if it can be demonstrated that "the activity would have been undertaken whether or not it included a solicitation of support."

There are two methods by which this can be demonstrated: (1) the "substantially all test," by which the charity does not have to report any of the costs of the activity as fundraising expenditures; or (2) the "four part test," by which the charity is only required to allocate a portion of the costs as fundraising expenditures. However, charities will likely find some aspects of the "four part test" to be unusually complicated, since at least one of the tests involves multiple layers of questions.

The primary focus of the guidance is the determination of a ratio of fundraising expenses to fundraising revenue calculated on an annual basis. The previous rigidity and arbitrariness of using five fixed-percentage ranges as an initial determination of the appropriateness of fundraising expenses was a major source of criticism of the earlier draft proposed by CRA in 2008, whereas the guidance now establishes a far more flexible approach.

The guidance introduces three fundraising ranges by which to evaluate a charity's fundraising ratio. A ratio below 35 percent will not likely generate questions or concerns by CRA. However, a ratio above 35 percent will cause CRA to examine the average ratio over recent years to determine if there is a trend of high fundraising costs, and a charity with a ratio above 70 percent will be required to provide an explanation to show CRA it is in compliance.

But the fundraising ratio is not intended to be considered in isolation. Instead, it is to be evaluated in conjunction with a number of mitigating factors, including a list of "best practices" and "areas of concern" indicators.

Despite improvements to the guidance, it still includes many of the concerns raised during the public consultation phase. While its language has been simplified and the length reduced, the substantive concepts remain largely unchanged. The guidance still constitutes a complex document that will likely prove difficult for charities to fully understand and easily implement.

While the more flexible and open-ended approach to evaluating fundraising activity is certainly an improvement, much of the criteria continue to be open to subjective interpretation, potentially leading to variations and inconsistencies in the interpretation of the guidance by both charities as well as by CRA auditors.

Although the best practices and areas of concern indicators are not requirements that must be followed by charities, some of those recommendations may prove challenging for charities to comply with. While there is no disagreement that transparency in and disclosure of fundraising costs is an important objective, the guidance's expectation of the disclosure may result in some charities encountering difficulty in attracting donors when it is necessary for the charity to disclose the estimated fundraising costs and revenues of its annual budget when seeking a donation from a prospective donor. As well, due to the time delays that often occur in fundraising campaigns from the time donations are requested to when donations are received, it would have been preferable if CRA had used a rolling average (for example, over several years) as the basis for evaluation of fundraising costs instead of doing so on a single fiscal year basis.

Given that the guidance is only intended to constitute a clarification of CRA's position on fundraising, as opposed to establishing a new policy, it will apply to audits in both future as well as past years. All registered charities that depend on fundraising, together with their staff, board members and professional advisors, should become familiar with it.

The ability of a charity to retain its charitable status in the future may very well depend on whether it can show that it has made reasonable efforts to meet the requirements of the guidance. ■

Terrance Carter is the managing partner with Carters Professional Corporation and is counsel to Fasken Martineau DuMoulin LLP on charitable matters.

How to plan for the increased U.S. estate tax exemption

CATHERINE EBERL

The increase in the U.S. estate tax exemption to $3.5 million presents both new planning opportunities and potential pitfalls for Canadian residents.

The estate tax exemption available to U.S. citizens and residents increased to $3.5 million on Jan. 1. The U.S. estate tax is set to repeal effective Jan. 1, 2010, but practitioners expect last-minute legislation that will keep the estate tax in place through 2010 and beyond, probably with a $3.5 million exemption.

A Canadian who owns U.S. assets, such as U.S. real property or stock in a U.S. corporation, is subject to U.S. estate tax at death. The U.S.-Canada Income Tax Treaty gives Canadian residents (other than U.S. citizens) a prorated exemption which is calculated by multiplying the exemption available to U.S. citizens (currently $3.5 million) by the value of the Canadian resident's U.S. situs assets over the value of worldwide assets.

Under this formula, the greater the percentage of a decedent's assets that are in the U.S., the greater the prorated exemption. Accordingly, U.S. estate tax exposure can often be minimized if U.S. property is owned by the "poorer" spouse.

For instance, take a typical situation of a Canadian couple who owns a vacation home in Florida. The husband's net worth is $2 million, all of which is located in Canada. The wife's net worth is $10 million, which includes $9 million in Canadian assets and the $1 million Florida vacation home. Under their current plan, if the wife dies first, all of her assets pass to the husband outright. After applying the prorated exemption, and assuming her estate claims the treaty marital credit, which effectively doubles the prorated exemption, the wife's estate would owe roughly $55,000 in U.S. estate tax. If the husband still owns the Florida home on his death, his estate would owe roughly $224,000 in U.S. estate tax.

Under the best planning, the Florida home would have been purchased through a U.S. trust, which would keep the house out of both spouses' estates. The wife could sell the house to a trust now, but the sale would trigger U.S. capital gains tax if the house has increased in value.

As an alternative, the couple's estate plan could be optimized by transferring the Florida home to the husband, who owns far less property in his own name. Spouses who are not U.S. citizens can only transfer up to $133,000 a year to each other without triggering the U.S. gift tax (this amount is indexed for inflation), so the transfer would have to be completed over several years. If the wife transfers the house to her husband and then he predeceases her, the exemption allowed to his estate, $1.67 million, would completely shelter the house from the estate tax. In addition, if they update their wills so that the house passes into a properly structured trust for the wife, the house will be sheltered from estate tax on her death. Overall, these simple changes would save roughly $279,000 in U.S. estate tax.

While the much higher U.S. estate tax exemption is good news in itself, it may have unintended results for cross-border couples. The typical estate plan for a U.S. citizen relies on a formula that gives the surviving spouse the "amount that will reduce the U.S. federal estate tax payable by my estate to the lowest possible amount." While this formula has the advantage of automatically adjusting to the frequent changes in U.S. tax law, the significant increase in the U.S. estate tax exemption over the last decade may have unintentionally altered older estate plans.

For example, assume a second marriage where the husband is a U.S. citizen living in Canada, and the wife is a Canadian citizen and resident. The husband has adult children from his first marriage. When the couple put their estate plan in place in 1998, the husband had a net worth of $4 million, and the U.S. exemption was $625,000. They agreed that if the husband died first, the husband's children from his first marriage should receive part of their inheritance immediately.

The husband's will includes the typical formula, giving the wife the amount necessary to reduce the federal estate tax to zero, meaning that she will receive any assets exceeding the exemption amount. He leaves the exemption amount to his children, intending that they would receive $625,000 and his wife would receive the balance of his estate.

In 2009, the husband's net worth is still $4 million, an assumption that might have seemed incredible until the recent economic collapse. Because of the increase in the estate tax exemption, $3.5 million now goes to the husband's children, and his wife must get by with only $500,000, a result that is far from their original intent.

Practitioners with clients who have U.S. estate tax exposure should review existing plans to determine if the increased exemption has altered the plan in an unintended manner. ■

Catherine Eberl is an attorney at Hodgson Russ LLP in Buffalo, who counsels clients on U.S. estates and trusts law.