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**DIVERSIONS OF CHARITABLE
ASSETS: CRIMES AND PUNISHMENTS
IN CANADA**

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“DIVERSIONS OF CHARITABLE ASSETS: MISUSE, SANCTIONS, AND ENFORCEMENT IN CANADA”

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A. INTRODUCTION

This paper is intended to provide a selective overview of legal issues involving the diversion of charitable assets and related misuse, sanctions and enforcement in Canada. The commentary provided in this paper spans a multitude of legislative, common law and policy directives in the Canadian context with regard to charitable assets that are diverted from their charitable purposes. Diversions of charitable assets can be intentional as well as unintentional, and can involve employees, volunteers, and officers, as well as members of the board of directors. Some aspects of director liability in this regard are discussed in a paper by the author entitled “Looking a Gift Horse in the Mouth” – Avoiding Liability in Charitable Fundraising.¹ The diversion of charitable assets to fund terrorist activities is addressed in an accompanying paper by the author, entitled “Charities and Compliance with Anti-Terrorism Legislation in Canada: The Shadow of the

^{*} The author would like to thank Suzanne E. White, B.A., LL.B., for her assistance in researching and compiling this article, Nancy Claridge, B.A., M.A., LL.B. Candidate, for her assistance in reviewing and proofreading, and Gisèle White, B.Sc., M.Sc., for formatting and revising the final paper. Any errors are solely those of the author.

¹ For a more in-depth discussion of director liability in this regard, see also “‘Looking a Gift Horse in the Mouth’ – Avoiding Liability in Charitable Fundraising”, by Terrance S. Carter, (Paper presented to the Canadian Association of Gift Planners, April 16, 2004), available at www.charitylaw.ca.

Law,”² which critiques Canada’s anti-terrorism legislation with regard to its impact on charities and their activities. Any discussion relating to anti-terrorism, charities, and associated financial transactions is therefore analyzed in the accompanying paper.

What this paper does address is a general overview of the changing landscape in Canada in relation to the responsibility of charities and their boards of directors to oversee charitable property raised from fundraising programs and the proper application of that property to appropriate charitable purposes, ensure the proper administration of a donor restricted charitable trusts, protect the intellectual property of a charity, as well as to avoid violations of applicable *Criminal Code*³ sanctions. This paper also discusses the major initiative by the Government of Canada in rewriting the rules concerning the taxation and administration of charities as it relates to the introduction of new sanctions and penalties. These proposals, as contained in the Federal Budget announced on March 23, 2004 and as reflected in draft legislation released by the Federal Government on September 16, 2004 (the “2004 Budget”)⁴, are the culmination of a decade of discussions between the federal government and the charitable sector in Canada regarding their respective requirements and responsibilities.

A number of terms used in this paper may not be readily identifiable to readers outside of Canada, and as such, a brief definition of these terms would be helpful for the reader who is not acquainted with Canadian legal terminology. For the purposes of this paper, a “charity” means a

² Terrance S. Carter, “Charities and Compliance with Anti-Terrorism Legislation in Canada: The Shadow of the Law”, presented at the New York University School of Law – National Center on Philanthropy and the Law 16th Annual Conference, October 28-29, 2004, available at www.antiterrorismlaw.ca and www.charitylaw.ca. An earlier version of this paper was published in *The International Journal of Not-for-Profit Law*, vol. 6, no. 3 (2004).

³ R.S. 1985, c. C-46.

⁴ For further discussion of the 2004 Budget, see also “March 2004 Budget Federal Budget Rewrites Tax Rules for Charities”, *Charity Law Bulletin* No. 41, by Terrance S. Carter and Theresa L.M. Man, also available at www.charitylaw.ca.

registered charity under the *Income Tax Act* (Canada) (the “ITA”)⁵ which is exempt from income tax and is able to issue charitable receipts for income tax purposes. A registered charity in Canada is the relative equivalent of a 501(c)(3) organization in the United States. Canada Revenue Agency (“CRA”) is the federal governmental agency which administers tax laws for the Government of Canada, as well as administers various social, economic benefit or incentive programs delivered through the tax system. CRA is the relative equivalent of the Internal Revenue Service in the United States. The Office of the Public Guardian and Trustee of Ontario (“PGT”) is a provincial government agency of the Ontario government which is responsible for protecting the public’s interest concerning charitable property in Ontario.

B. COMMON LAW SANCTIONS WITH REGARD TO FUNDRAISING⁶

In recent years, Canadian courts, particularly in Ontario, have had the opportunity to more clearly define the legal responsibility of charities and their boards of directors with respect to overseeing fundraising programs. Despite long-standing statutory and common law obligations, most directors of charities generally consider the legal responsibility for fundraising to lie with either the professional fundraisers who are retained or employed by the charity or with the management of the charity. The primary tool for evaluation of fundraising efforts by boards of directors is generally based upon monetary performance and the financial results achieved instead of exercising the due diligence required from them at law to review the appropriateness of fundraising programs and how the monies raised are applied.

⁵ R.S.C. 1985, c. 1 (5th Supp.).

⁶ Part of this section of the paper was previously published in "Pro-Active Protection of Charitable Assets": A Selective Discussion of Liability Risks and Pro-Active Responses, by Terrance S. Carter, November 20, 2001, also available at www.charitylaw.ca.

While the boards of directors of most large charities do evaluate the cost effectiveness of fundraising practices of their respective organizations, a survey published by the Canadian Centre for Philanthropy found that the same boards generally do not take an active role in reviewing policy issues related to fundraising.⁷ This general lack of interest in reviewing the policies and risks associated with fundraising is not consistent with the fiduciary duty placed upon directors to exercise prudence in overseeing the operations of a charity and protecting its charitable property.⁸ The duty of directors to be reasonable, prudent and judicious in this regard has been succinctly summarized by the PGT:

Directors and trustees must handle the charity's property with the care, skill, and diligence that a prudent person would use. They must treat the charity's property the way a careful person would treat their own property. They must always protect the charity's property from undue risk of loss and must ensure that no excessive administrative expenses are incurred.⁹ [Emphasis added]

1. The AIDS Society for Children (Ontario) Case

The high fiduciary duty placed upon directors of charities in relation to fundraising programs was underscored in the case of *Ontario (Public Guardian and Trustee) v. The AIDS Society for Children (Ontario)*.¹⁰ The AIDS Society for Children (Ontario) (the "AIDS Society") was incorporated on November 28, 1994, and obtained charitable status from CRA three days after the date of incorporation on December 1, 1994. The AIDS Society operated offices in various southern Ontario cities and distributed pamphlets

⁷ Michael H. Hall, *Charitable Fundraising in Canada* (Toronto: Canadian Centre for Philanthropy, 1996) at 53.

⁸ Ontario Law Reform Commission, *Report on the Law of Charities*, Vol. 2 (Toronto: Ministry of the Attorney General, 1996) at 570.

⁹ "Duties, Responsibilities and Powers of Directors and Trustees of Charities" *Charities Bulletin No. 3: Information from the Public Guardian and Trustee's Charitable Property Program* (Toronto: Office of the Public Guardian and Trustee of Ontario, July 1999), available at www.attorneygeneral.jus.gov.on.ca.

¹⁰ *Ontario (Public Guardian and Trustee) v. The AIDS Society for Children (Ontario)*, [2001] O.J. No. 2170 (Ont. Sup. Ct. Jus.) (the "AIDS Society for Children (Ontario)").

indicating that the monies raised from public donations would be used to build a home (hospice) for children living with HIV/AIDS. The AIDS Society subsequently entered into fundraising agreements with two fundraising companies in 1996. One company was retained to solicit charitable donations from the public by telephone. The other company was retained to solicit charitable donations using door-to-door canvassing. The contracts with the third-party fundraising companies involved different arrangements, but both required that all expenses involved with the applicable fundraising were to be paid by the AIDS Society and that the fundraising company would then receive a percentage of the remaining amount raised.

Of the \$134,380.00 raised by the telephone campaign, 76% of those monies, or \$102,216.00, was paid to the fundraising company for its fees and expenses, with only the remaining 24%, or \$32,163.00, being paid to the AIDS Society. Of the \$241,012.00 raised through door-to-door canvassing, 80% of the monies raised or \$193,238.00 was paid to the fundraising company for its fees and expenses, and only the remaining 20% or \$47,774.00 was paid to the AIDS Society. In 1996, the PGT began receiving complaints from the public, other AIDS organizations and the media about the AIDS Society, charging that the AIDS Society was not applying its funds for its charitable purposes. The PGT discovered, from admissions of the Directors of the AIDS Society, that despite raising \$921,440.00 through public donations, no funds had been expended on the charitable programs of the AIDS Society and that the AIDS Society was, in fact, in debt. Through an initiative of the PGT, the activities of the AIDS Society were suspended by the court and the PGT was made trustee of all of its assets.

In 1997, CRA subsequently revoked the charitable registration number that it had issued to the AIDS Society. The PGT brought an application for the passing of accounts pursuant to the *Charities Accounting Act* (Ontario) (the “CAA”).¹¹ In the course of making the application, the PGT sought directions from the court concerning a number of questions:

- Is the AIDS Society and/or its directors responsible as fiduciaries to the public for all of the funds collected from the public, including the gross amount of funds received by the two fundraising companies?
- What is the nature of the legal relationship between the individual donor, the canvasser, the unit/crew manager, the fundraising companies and the AIDS Society?
- Does the duty to account by the fundraising companies extend to the gross receipts collected from the donors on behalf of the AIDS Society?
- Is all or part of the fundraising agreements void or voidable as being contrary to public policy or for some other reason?
- Did the AIDS Society offend the 80/20 disbursement rule under the *ITA*, and, if so, what is the effect, if any, upon the contractual arrangements between the AIDS Society and the fundraising companies?

¹¹ R.S.O. 1990, c. C.10.

In its decision, the court first reaffirmed that it had inherent jurisdiction to direct or control the administration of charities and that the PGT, as nominee of the Attorney General, acts in a *parens patriae* role in overseeing the administration of charitable property in accordance with the power historically given to the Crown over charities and charitable property. As a result, the court therefore had no difficulty in exercising jurisdiction in responding to the the PGT's questions.

Similarly, the court held that directors of a charity, although not strictly trustees, at law have a fiduciary obligation to the charity and its charitable property. The court went on to explain that while a fiduciary is someone who stands in a position of trust to another individual, a fiduciary relationship does not require that a "true trust" relationship exist. Accordingly, it is not necessary that the legal title of property be held in trust for another individual, only that there is a legal obligation on the part of the fiduciary to another individual to put the interest of that other individual ahead of the interests of the fiduciary.

The comments and answers provided by the court in response to the questions submitted to it by the PGT are summarized below.

a) Fiduciary Duty to the Public for Funds Raised

Although charitable corporations do not hold their unrestricted property as trustees for the general charitable purposes of the charity, a fiduciary obligation attaches to property that the charity receives for its charitable purposes. As such, the AIDS Society, as a fiduciary of the monies donated to it, is responsible to account to the public for all monies publicly raised from it, including the gross amount of monies

raised by the fundraising companies, not simply the net balance that was eventually turned over to it by the fundraising companies. Similarly, the directors of the AIDS Society have a similar fiduciary duty to account for all of the monies raised by the AIDS Society from the public and to utilize such monies to further the objects of the AIDS Society as a charitable institution.

Without commenting upon whether or not entering into the fundraising agreements were in fact a breach of fiduciary duty, the court was careful to point out that a fiduciary relationship can be breached whether or not a loss occurs. As a result, the fact that a charity and its board of directors may have entered into an improvident fundraising contract may in and of itself be a breach of their fiduciary duty to the public, regardless of whether or not any loss subsequently occurs.

b) Legal Relationships

The court found that the contract entered into between the AIDS Society and the fundraising companies established a principal/agent relationship. This means that the actions of the fundraising companies are deemed to be the actions of the AIDS Society as its agents, thereby exposing the AIDS Society to liability as the principal. As agents of the AIDS Society, the fundraising companies had a duty to account for the monies received by it on behalf of the AIDS Society, although not necessarily a fiduciary duty. The court stated that upon the passing of accounts, aspects of a developing fiduciary relationship between the fundraising companies and the Aid Society would likely become clearer in relation to the duty of the fundraising

companies to account for the monies raised from the public on behalf of the AIDS Society.

The court explained that there is a fiduciary obligation placed upon the AIDS Society and its directors to apply the monies raised from the public for the purposes of the AIDS Society. However, there is no legal relationship between donors and the fundraising companies, their canvassers, and/or their unit/crew managers.

c) Scope of Duty to Account

As agents of the AIDS Society, the fundraising companies have a duty to account for the gross amounts of monies raised as donations from the public and not simply the net amount that was to be paid to the AIDS Society by the fundraising companies pursuant to the terms of the fundraising contracts.

d) Voiding Fundraising Agreements as being Contrary to Public Policy

The court indicated that courts in the past have been normally loath to interfere with freedom of the parties to enter into contracts. However, given public charitable giving, the nature of the administration of charitable property, and the fact that donors were not advised that between 70% to 80% of the donations would be deducted for expenses, the court held that the fundraising contracts could be voidable as being contrary to the public interest. The voidability of the contracts would be based upon breach of public policy and misrepresentation to donors concerning the amount of monies raised that was actually going to fulfill the charitable purposes of the AIDS Society.

e) The 80/20 Disbursement Rule under the *ITA*

Although it was recognized that the failure of the AIDS Society to comply with the 80/20 disbursement quota under section 149.1 of the *ITA* (i.e. a registered charity must expend at least 80% of the receipted income that it receives in previous years in pursuing charitable activities) might be a material factor to be considered by the court, it was held that there was no evidence available before it to determine whether or not the disbursement quota under the *ITA* had been complied with. Therefore, the court declined to comment upon the impact of the 80/20 disbursement quota rule in relation to the AIDS Society.

2. Implications of the *AIDS Society for Children (Ontario) Case*

A number of implications can be drawn from the court's decision in the *AIDS Society for Children (Ontario)* case.

First, although the court confirmed that unrestricted gifts to charities are owned by the charity beneficially, and not held in trust for the charitable purpose of the charity, the charity still has a fiduciary obligation to apply the gifts received for its charitable purposes. As a fiduciary, a charity has some of the characteristics of a trustee, including the responsibility to account for the application of funds that it receives from the public.

Second, a charity is responsible as a principal for the actions of its fundraiser, and any subcontractors of the fundraiser, as agents of the charity. A charity cannot avoid responsibility for its fundraiser by describing it as an independent contractor.

Third, if a charity engages fundraisers for the purpose of soliciting funds, regardless of whether or not the fundraiser is entitled to receive some portion of the funds raised, the charity is responsible to account for the gross amount of all donations received from the public, and not simply the net amount payable to the charity in accordance with the contract with the fundraisers.

Fourth, the charity, as principal, has the power to require the fundraiser, or subcontractors of the fundraiser, to account for the full amount of monies that the fundraiser has raised, and the charity must do so in accordance with the fiduciary relationship between the charity and the public.

Fifth, the directors of a charity stand in a fiduciary relationship to a charity akin to that of a trustee. Therefore, directors have a fiduciary relationship not only to the charity but to the public at large. Directors of charities are personally responsible to account for all monies raised by its fundraisers and their sub-contractors.

Sixth, exposure to liability by the charity and its board of directors is not limited to losses of charitable monies only. Rather, the fiduciary relationship will have been breached if the charity and its directors are found to have entered into a contract which may tend to cause a prejudice to the charity. Directors of a charity must therefore proactively review, approve and oversee all fundraising activities of a charity, including the terms of contractual relationships with professional fundraisers.

Seventh, although there is a distinction at law between a charity receiving unrestricted gifts as property, of which it holds beneficially for its charitable purposes, and gifts received in

trust for specific charitable purposes, there is little difference in a practical sense given the fact that a charity and its board of directors have a fiduciary obligation to the public to apply the funds received for its charitable purposes,. A finding of a breach of fiduciary duty by a charity and its board of directors could be every bit as damaging as a finding of a breach of trust.

Eighth, given the fiduciary obligation of a charity and its board of directors to apply donations received by a charity for the stated charitable objects of the charity, it is essential that a charity carefully review its charitable objects on a regular basis and revise and/or expand them as necessary, i.e. to include the ability to make donations to other qualified donees.

Finally, given that a fundraising contract can rendered voidable if there was a misrepresentation to the public by fundraisers by not disclosing fundraising costs, the determination of the fiduciary obligation between the charity and its donor is a subjective one in the minds of the donor, i.e. what did the donor think that the donation would be used for. As a result, it is essential that a charity review all aspects of fundraising literature and communication to determine what impression is left with the donor concerning the application of donations by the charity. This determination of the reasonable interpretation by a donor concerning how the funds would be used will become the standard by which the charity and its board of directors in the future will be called to account in relation to the fulfillment of their fiduciary duty.

3. The Passing of Accounts for the AIDS Society

Based upon the directions given by the court, the PGT proceeded with a judicial passing of accounts of the AIDS Society. As the judgment only provided answers to questions put to the court, the significance of the judgment lies more in conclusions that can be drawn from the monetary impact of the answers to the questions than in any substantive comments that might add to what the court had said in its earlier decision.

The court was asked whether the fundraising contracts between the AIDS Society and the two fundraising companies were void for being contrary to public policy. In this regard, it was alleged by the PGT that the contracts should be found void because the percentage of fundraising costs was unreasonable. The court answered that the contracts were indeed void as being contrary to public policy because the fundraising contract provided that seventy to eighty percent (70%-80%) of the proceeds were to be paid to the fundraising companies, a clear diversion of charitable funds to an improper purpose. The consequences of this decision are significant for charities, their directors, and third-party fundraising companies where the payment under a fundraising contract entitles the fundraising company to receive a high percentage of the donations, i.e. 70%. It is not clear whether other similar fundraising contracts would be found to be void as being contrary to public policy. However, given the judicial pronouncement in this case and in the *Ontario Public Guardian and Trustee v. National Society for Abused Women and Children* (“*National Society for Abused Women and Children*”)¹² case there is a distinct possibility that other similar types of fundraising contracts might be found void by the courts. It would therefore be important for both charities and third-party fundraising companies to

¹² [2002] O.J. No. 607 (Sup. Ct. Jus.) (“*National Society for Abused Women and Children*”).

carefully review the terms of their fundraising contracts to ensure that the resulting percentages of fundraising costs will not be found objectionable in the opinion of the court, or in the alternative, to seek direction of the court if there is uncertainty in this regard.

The court was next asked whether the fundraising contracts, if not found void based on unreasonable fundraising costs, would be void as being contrary to public policy because of a violation of the 80/20 disbursement quota under section 149.1 of the *ITA*. The 80/20 disbursement quota requires a charity to spend 80% of the cash value of its receipted donations in the following year on programs, not administration or fundraising. The court declined to answer this question, since it had already determined that the fundraising contracts were void. However, the mere fact that the PGT submitted to the court that non-compliance with the 80/20 disbursement quota might void a fundraising contract on this basis will mean that charities and their directors will need to determine whether there is compliance with the 80/20 disbursement quota in relation to fundraising expenses, an issue that is not always easy to get clarity on.

Having found that the fundraising contracts were contrary to public policy, the court was next asked what percentage of the disbursement paid by the AIDS Society to the fundraising companies could be kept by those companies as reasonable fundraising costs. The court answered that none of the fundraising costs were reasonable. Whether this blunt response was based on the fact that no monies had been used for the charitable purpose of the AIDS Society or because the percentage of fundraising costs was excessive is not clear. However, what is evident is that where fundraising contracts are found to be void, the courts may have no alternative but to find that all of the fundraising costs, even those at a

lower percentage, are an unreasonable diversion of charitable assets that cannot be justified. In other words, too high of a percentage share of fundraising proceeds may result in voiding all of the fundraising costs, not just the fundraising costs above an acceptable amount, whether that reasonable amount is determined to be the statutory 20% provided for under the 80/20 disbursement quota under the *ITA* or some other percentage.

Having found that the fundraising contracts were void as being contrary to public policy and that no fundraising costs or disbursements in the accounts were acceptable as reasonable fundraising costs, the court was then asked to determine whether the AIDS Society and its three (3) directors were liable for the amount of disallowed disbursements. The court answered that both the AIDS Society and all three of its directors were liable for the disbursements and determined that they were liable for \$736,915.71 in unreasonable fundraising costs. This liability was joint and several to each of the directors. What is important to note is that the breach of the directors' fiduciary duty arose from the fact of having entered into an imprudent contract, not from any conflict of interest or any personal benefit they might have received from the transaction, as was the situation in the *National Society for Abused Women and Children* case.

The court was then asked whether the two fundraising companies were liable for the unreasonable fundraising costs along with the AIDS Society and its directors. The court answered that the fundraising companies were liable on a joint and several basis with the AIDS Society and its directors. Given the court's extension of liability to the fundraising companies to repay fundraising costs they had received, third-party fundraising companies will now have a vested interest in ensuring that their fundraising contracts are acceptable to

the courts and to the PGT for their own protection, in addition to ensuring that fundraising contracts are legal from the standpoint of their clients.

The court was then asked whether or not the matter was an appropriate case to impose a penalty by way of a fine upon the AIDS Society and the fundraising companies pursuant to section 4(k) of the CAA¹³. In this regard, section 4(k) of the CAA provides as follows:

(k) imposing a penalty by way of fine or imprisonment not exceeding twelve months upon the executor or trustee for any such default or misconduct or for disobedience to any order made under this section;

The court answered the question by imposing a \$50,000.00 penalty upon the directors of the AIDS Society, but surprisingly did not do so to either the AIDS Society or the fundraising companies. The decision not to impose a penalty upon the AIDS Society likely reflects the fact that the AIDS Society did not have any assets. The fact that the directors of the AIDS Society were the ones held liable for the \$50,000.00 penalty underscores the fact that, at the end of the day, where a charity itself is held liable at law for a matter, the directors of the charity will generally be held to account personally for their failure to adequately manage and protect the charitable property entrusted to them.

The final question that the court was asked to determine was “what should be done with the \$37,935.50, which the court was holding in trust.” It was decided that those monies would be paid between two (2) charities presumably having similar charitable purposes to the AIDS Society in accordance with the *cy pres* jurisdiction that the courts exercise over

¹³ R.S.O. 1990, c.C.10 (“CAA”).

charitable property, i.e. to apply the property as “near as possible” to its original charitable purpose.

Given the devastating financial consequences in the *AIDS Society for Children (Ontario)* case, directors of charities may also need to look at the fundraising costs associated with retaining fundraisers as employees as well, since the court did not draw a distinction between the cost of third-party fundraising arrangements and employing fundraisers in relation to determining what are reasonable fundraising costs. Further, the court did not articulate what constitutes reasonable fundraising costs, making it difficult for directors of charities, as well as third-party fundraising companies, to know what will be acceptable to the court, a situation that will exist until the legislature or courts provide guidance.

4. *The National Society for Abused Women and Children Case*

In another third-party fundraising contract case, *National Society for Abused Women and Children*, the court came to many of the same conclusions as in the *Aids Society for Children (Ontario)* case. The case involved three individuals who incorporated the National Society for Abused Women and Children (the “Society”) in 1999, subsequently arranged for the Society to obtain charitable status, and then entered into fundraising contracts with businesses that the directors of the Society either owned or with which they were employed. The fundraising efforts for the Society raised close to \$1-million, but only \$1,365 made its way to charitable work. The fundraising contracts provided for percentage commissions of between 75% to 80% of the gross funds raised, together with additional monthly administrative fees on one of the contracts of \$1,500 per month.

The court found that the fundraising contracts were void *ab initio*, as the amount of compensation paid to the fundraising companies under the contracts was found to be unconscionable. This resulted in the court requiring the directors of the Society to pay all monies that they had received from the Society through the fundraising companies over to the PGT. Once the monies had been paid over to the PGT, then the directors could seek compensation, but only if such claims for compensation were properly documented and received, subject to approval by the court.

Given the brevity of the decision, the intensity of the comments by the presiding Judge, and the serious consequences arising from the court's decision for charities in Ontario, the decision is set out in its entirety below, followed by a commentary on some of the practical implications of the decision.

“LOUKIDELIS, J.

1. A distinct odour emanates from the facts of this case.
2. The ability and swiftness by which the main principals or indeed anyone acting within the system can extract from trusting citizens a large amount of money is rather stunning.
3. Here the 3 main principals Perrin, Corriero and Dobbs without any background training or expertise in child or women abuse, but only a stated desire “to give something back”, obtained a charter for a non-profit organization, the objects of which were to “promote awareness...and to assist abused women and children”. The 3 named were the first directors. The corporation was given a high sounding name. The charter was issued March 2, 1999. Its objects were approved by the applicant and it was registered as a charitable organization. They were then ready to do business.
4. Thereafter, they proceeded without advice to break statutory, common law and common sense rules, mixing their personal interest with those of the Society in a totally inappropriate manner.

5. The laudable objectives were used as a cover to raise from unsuspecting donors close to 1 million dollars of which \$1,365 actually found its way to a deserving charity.
6. Thanks to the vigilance of the press the Society's fundraising methods and the conduct of its directors was brought to the applicant's attention resulting in this application.
7. The Society entered into 3 separate fund raising contracts between March 1999 and March 2000, all of which were shocking, paying to the collecting agency 75 to 80% of gross receipts.
8. The first was Community Fundraising Consultants, a now defunct company where Corriero and Dobbs at the time were both employed. This was an obvious conflict of interest that all 3 directors should have known.
9. There was no indication that the directors searched for other agencies with better rates. The suggestion that other new charities engaged this type of collector is not a valid answer.
10. The second contract was with a partnership known as Canadian Care Marketing Associates – the partners being Perrin and Corriero. While the commission was 75% rather than 80% of gross receipts there was an additional \$1,500 monthly charge.
11. Contrary to Perrin's evidence I am satisfied that at the time that contract was signed, Perrin and Corriero were still directors of the Society; a clear conflict of interest and breach of their fiduciary duty as directors of a charitable organization. I note also that this contract was for 3 years which places in considerable doubt their now stated position that the contract was a temporary measure until a data base of contributors had been established.
12. The third contract was with OFC Charity Call Centre.
13. The whole operation was a scheme whereby charity was used as a cover to raise money for the benefit of the collection agency.
14. While the principals did collect some clothes and toys and distributed same, these items were donated to them at no cost. They were careful also to collect some thank you letters.

15. Mr. Andreou raised a spirited argument on behalf of the respondents. I cannot accept that the principals were naïve or that this is the accepted and appropriate manner of doing things for new charities.
16. Corriero and Perrin profited in numerous ways because of their conflicts and by breaching their fiduciary duties as directors. They had no right while directors, or after, to charge food and car expenses to the Society. Perrin's claim for reimbursement of a loan is undocumented.
17. They also charged partnership expenses to the Society when they carried on their business from the same location as the charity.
18. The inappropriateness of their conduct is more particularly set out in the detailed letter of administrative fairness from Revenue Canada dated September 29, 2000.
19. Ms. Dobbs also received a personal benefit by way of expenses which was improper.
20. These 3 principals particularly Corriero and Perrin, treated the Society as a personal fiefdom with a nice treasury for their own purposes.
21. I am not prepared, therefore, to approve the Society's accounts as stated.
22. Each of the 3 principals should repay all monies received from the Society if demanded by the applicant. Upon submitting proper documentation in support to their claims, approval by the Court may be granted after which they will be paid by the applicant from funds ordered to be returned.
23. If there is a dispute as to the amount owing by each, the applicant may arrange to reattend before me to determine the amount from the material already filed.
24. The contract between Canadian Care Marketing Associates (CCMA) and the Society was obviously improper at the time and was, I find, void *ab initio*. The profit shown by CCMA on its filed statement of some \$28,000 should also be paid to the applicant by Corriero and Perrin.
25. Turning now to the issue of the collection agencies. Their share of 75 - 80% of gross receipts if known, is bound to shock the conscience of any citizen. If any prospective donor knew the true facts, I doubt that a penny would have been given. They claim to speak for a charity, but are careful not to reveal what the charity will

receive. The main beneficiary is the collection agency. If not an outright fraud, it is clearly wrong.

26. Every charitable donor expects a charity to have some administrative costs. But in circumstances like this where the actual amount used for charitable purposes was a fraction of 1%, it is clearly unconscionable.
27. Some mechanism should require canvassers for such collection agencies to be forthright in divulging collection and administration costs.
28. If any funds are collected as a result of my order, the applicant hopefully might distribute same to authorized shelters in the areas where these funds were collected.
29. The Society as well as the respondents or their agents are prohibited from seeking further donations from the public on behalf of the Society.
30. Also the respondents Corriero, Perrin and Dobbs are prohibited from acting as directors of any other charitable organization until the accounts of the Society have been approved.”

The intensity of the comments by the court reflect the offensive nature of the facts involved in the case. Still, there are practical consequences of the decision, not limited to the specific fact situation involved with this particular charity, that are of importance for any charity that fundraises by utilizing third-party fundraising companies.

The court’s finding that the compensation to third-party fundraisers was unconscionable and would “*be bound to shock the conscience of any citizen,*” notwithstanding that it was argued that the fundraising practices of the Society were similar to those carried out by other new charities and were done for purposes of establishing a database for future contributions, would suggest that the court will compare fundraising expenses to the gross amount of donations received in the same year, instead of amortizing those expenses over a number of years to reflect the long-term benefit of the fundraising database that was being established.

The court found that the three directors of the Society were in a clear conflict of interest when they arranged for the Society to enter into contracts with fundraising companies that were either owned by them or employed by them. The court held that by entering into these contracts, the directors breached their fiduciary duty as directors of the Society. For background information concerning the common law rule prohibiting remuneration of directors of charities, as well as a discussion of the decision by the PGT not to introduce regulations to permit remuneration of directors, the reader is directed to an article by the author, entitled “Remuneration of Directors in Ontario and Update of Remuneration of Directors in Ontario”.¹⁴ The practical difficulty that can arise from conflicts of interest where directors receive, either directly or indirectly, remuneration from a charity is made all the more problematic in extreme fact situations such as the one in this case.

Once the court identified that the directors of the Society were in conflict of interest by directing the Society to enter into the fundraising contracts, the court went on to require that the directors account for all monies that they had received from the fundraising companies that they either owned or were employed by. This aspect of the decision underscores that where directors of a charity are found to be in breach of their fiduciary duties, the directors will personally be liable to repay the monies that they have received back to the charity, whether such monies have been received directly or indirectly, including monies received through fundraising contracts.

The court also confirmed the fiduciary duty that directors in Ontario have to disclose unreasonable fundraising costs to donors. This decision of the court is similar to the

¹⁴ Available at www.charitylaw.ca. See also “Utilizing Ten Year Gifts in Charitable Fund Raising” by Terrance S. Carter, *Charity Law Bulletin No. 2*, March 20, 2001, available at www.charitylaw.ca.

position taken by the court in the *Aids Society for Children (Ontario)*, discussed above, in which the court held that directors of a charity have a fiduciary obligation to disclose excessive fundraising costs to donors. In the *National Society for Abused Women and Children* decision, the court was particularly critical of the fundraising arrangement that allowed a fundraising company to “*speak for the charity*” and receive 75% to 80% of the gross receipts, but failed to disclose what those costs were and what the charity was actually receiving. This aspect of the decision emphasizes that directors of a charity have a fiduciary obligation to ensure that fundraising expenses are kept within the reasonable expectations of donors. However, just what constitutes the reasonable expectations for fundraising expenses was not identified by the court., nor was there any reference to the 80/20 disbursement quota rule required for registered charities under the ITA. However, what is clear from the decision is that fundraising administrative costs of 75% to 80% of gross receipts was sufficiently high to constitute an improper diversion of charitable assets..

The common law fiduciary obligation placed upon directors of a charity would appear to be in addition to the increasing legal obligations imposed upon directors by statute concerning fundraising, such as the requirements under the federal *Competitions Act*,¹⁵ the federal *Personal Information Protection and Electronic Documents Act*,¹⁶ and Ontario’s fledgling attempts to introduce its own privacy legislation.¹⁷

It is possible that the decision of the court in the *National Society for Abused Women and Children* case, as well as the earlier decision in the *Aids Society for Children (Ontario)*

¹⁵ R.S.C. 1985, c. C-34.

¹⁶ S.C. 2000, c. 5.

¹⁷ Ontario’s Bill 159, *Personal Health Information Privacy Act*, died on the order paper in 2001. The Ontario Ministry of Consumer and Business Affairs released draft privacy legislation – the *Privacy of Personal Information Act, 2002* – in February 2002 for public comment, but has not yet moved forward with any legislation.

case, may become the impetus for fundraising legislation in Ontario similar to what has been put in place in other provinces, such as Alberta.¹⁸ Whether the provincial Government, the charitable sector, or the third-party fundraising community will take the initiative in this regard remains to be seen.

The *National Society for Abused Women and Children* decision is important for the numerous observations, findings and conclusions of the court concerning the inappropriateness of fundraising activities carried out by the Society, as well as the recognition that the PGT will not hesitate to seek an order for a judicial passing of accounts under the CAA where fundraising arrangements are considered to be patently unreasonable. It will now be more important than ever for charities that are fundraising in Ontario to be diligent in ensuring that they not only comply with statutory requirements involving fundraising, but also comply with common law fiduciary duties imposed upon directors of charitable corporations in relation to the expectations of donors concerning reasonable administrative expenses involved in fundraising. It is clearly a new day in Ontario, and possibly across Canada, for charitable fundraising that will need to be closely monitored by charities, their directors, legal counsel who advise them, professional fundraisers, as well as the third-party fundraising community.

There are serious legal consequences that directors may face if they allow a charity to become involved in an improper fundraising practice. Those consequences range from

¹⁸ The *Charitable Fund-raising Act*, R.S.A. 2000, c. C-9, regulates, inter alia, procedures for soliciting contributions, fund-raising businesses, and fund-raising agreements, and provides a means for the government to suspend or cancel the registration of a charitable organization or the licence of a fundraising business or any of its principals, directors or managers, if they are found in the Minister's opinion to be in contravention of the Act.

breach of trust, public inquiries under the *Public Inquiries Act*,¹⁹ as well as a court ordered audit under the *CAA*. As a result, it is essential that the charity's board of directors understand that it has both a legal obligation and vested personal interest in ensuring that the fundraising programs undertaken by a charity are carefully scrutinized in order to evidence that the board of directors has exercised the due diligence required of it in its fiduciary capacity to manage and protect the charitable property that has been entrusted to it. In addition, Canadian criminal legislation also imposes stiff penalties for the misuse of charitable assets.

C. CRIMINAL SANCTIONS WITH REGARD TO FUNDRAISING

Criminal sanctions for the improper diversion of charitable assets are a little utilized but important tool in the regulation of charities in Canada. However, considerations must be given to the high standard required to prove the essential elements of the offences, and a charity's reluctance to bring bad publicity to their organization in pursuance of a charge. Still, as the public is the ultimate beneficiary of charitable funds, there is a duty upon authorities to employ available tools when necessary.

A criminal breach of trust, as set out in the *Criminal Code*, is considered to be an offence resembling theft by persons in positions of trust, providing a criminal sanction for the improper diversion of charitable assets. Section 336 of the *Criminal Code* provides that:

Every one who, being a trustee of anything for the use or benefit, whether in whole or in part, of another person, or for a public or charitable purpose, converts, with intent to defraud and in contravention of his trust, that thing or any part of it to a use that is not authorized by

¹⁹ R.S.O. 1990, c. P-41.

the trust is guilty of an indictable offence and liable to imprisonment for a term not exceeding fourteen years.

Often seen employed in the context of a lawyer improperly diverting trust monies, the offence does not require that the victim, in this situation the charity, suffer actual economic loss. Rather proof of detriment, prejudice or risk of prejudice to the charity's economic interests is sufficient to support the charge. The dearth of cases on point relating to the diversion of charitable assets is likely evidence of the high bar that is set for authorities to prosecute such a charge rather than the scarcity of charity directors diverting funds to improper purposes.

What the case law does indicate is that there is no requirement that the accused actually intend to cause detriment to the beneficiary or to put the beneficiary at risk. For example, in *R. v. Atkins*²⁰, after more than five years of legal wrangling, the Crown Prosecutor in Ontario stayed charges against six former board members of a rape-crisis line who allegedly used monies from a charitable trust account to help pay legal fees for the former executive director who had been convicted of defrauding the same crisis line.²¹ It was the board's unanimous position that the former executive director did not defraud the crisis line and it was only fair that she be reimbursed for her legal costs. As such, it was proposed that surplus monies be used in this regard. In a decision to commit the board members to trial, the court looked to a variety of factors to demonstrate the intent to defraud, including:

- the Letters Patent of the corporation setting out the limitations on the use of the corporation's funds;

²⁰ [2000] O.T.C. 856 (Sup. C.J.) ("*R. v. Atkins*").

²¹ Michele Landsberg, "Where's the justice?" *The Toronto Star* (13 September 2003), LO1.

- the accused’s presence at board meetings wherein they voted in favour of making the payments;
- the payment of the monies to the former executive director;
- letters from government bodies which put the Board on notice with explicit directions about the use of lottery funds and a further direction not to pay the former executive director’s expenses;
- auditor’s testimony that there were not sufficient funds in the general account to cover the payments; and
- the transfer of funds from the trust account to the general account.

While all counts of fraud on the public were dismissed, the court was satisfied that the evidence was sufficient to commit the accused on charges of criminal breach of trust and theft.

In a similar vein, authorities have also turned to laying charges of fraud in relation to improper fundraising practices and the consequent improper diversion of charitable assets. Although the bar is set high for the Crown to prove the various elements of the offence, the Supreme Court of Canada, in *R. v. Theroux*²², held that the required proof of “subjective knowledge that the prohibited act could have as a consequence the deprivation of another” does not require that the accused subjectively believe his or her act is dishonest before he or she will have the required *mens rea*. In *R. v. Zins*²³, a case in which the accused operated a telemarketing scheme where he

²² (1993), 79 C.C.C. (3d) 449.

²³ [2002] O.J. No. 1343 (Sup. C.J.), aff’d by [2002] O.J. No. 4529 (C.A.).

posed as a fundraiser for local firefighter associations, collecting over \$100,000 in a three-month period, the court found the accused's prior participation in legitimate fundraising ventures to constitute the requisite subjective knowledge.

Charities that discover incidents of fraud or criminal breach of trust will likely be concerned about the practical consequences of reporting such offences, since the fraudulent use of charitable funds is likely to result in publicity that is adverse to future fundraising activities. However, under section 141 of the *Criminal Code*, it is an offence to conceal an offence. In addition, insurance companies will likely require that the offence be reported to police in order for the losses to be insured in order to effectively investigate such incidents. Charities that become embroiled in a criminal fraud investigations may also be exposed to certain tax and civil penalties discussed below.

D. ADMINISTRATION OF CHARITIES UNDER THE CANADIAN TAXATION REGIME²⁴

The Federal Budget announced on March 23, 2004, (the "2004 Budget") represents a major initiative by the Federal Government in rewriting the tax rules concerning the taxation and administration of charities. The 2004 Budget reflects to a large extent the proposals of the Voluntary Sector Initiative's Joint Regulatory Table contained in its report of March 2003 "Strengthening Canada's Charitable Sector: Regulatory Reform," particularly as it relates to intermediate taxes and sanctions. The 2004 Budget also rectifies a number of technical problems regarding disbursement quotas involving charities, most of which were identified in submissions by the Charities and Not-for-Profit Law Section of the Canadian Bar Association over the last

²⁴ A portion of this section was previously published in "March 2004 Federal Budget Rewrites Tax Rules For Charities" by Terrance S. Carter and Theresa L.M. Man, *Charity Law Bulletin* No. 41, dated March 30, 2004, available at <http://www.charitylaw.ca>.

three years. The proposals that are set out in the 2004 Budget should be read in addition to the February 27, 2004 Revised Draft Technical Amendments.²⁵ Draft legislation to enact the 2004 Budget was introduced by the federal government on September 16, 2004.²⁶

Some of the key proposals from the 2004 Budget affecting charities are as follows.

1. Intermediate Taxes and Penalties

Prior to the 2004 Budget, the only sanction that CRA could impose on a registered charity that did not comply with the requirements of the *ITA* was to revoke its status as a registered charity. The consequence of revocation is that the registered charity must either transfer its assets to one or more qualified donees within one year of the date of revocation or pay a 100% tax on the remaining property of the registered charity. This tax is referred to as a revocation tax under Part V of the *ITA*.

To overcome the harshness of imposing revocation for minor infractions, the 2004 Budget proposes a more responsive approach to the regulation of charities under the *ITA* by introducing sanctions that are more appropriate than revocation for relatively minor breaches of the *ITA*. The sanctions will be progressive, generally increasing in severity for repeat infractions. These measures will apply in respect of taxation years that begin after March 22, 2004. The proposed sanctions and taxes can be summarized as follows:

²⁵ See also “February 27, 2004 Revised Draft Amendments to the *Income Tax Act* Affecting Charities” by Theresa L.M. Man and Terrance S. Carter., *Charity Law Bulletin* No. 40, March 29, 2004), available at <http://www.charitylaw.ca>, and “Recent Changes to the *Income Tax Act* and Policies Relating to Charities and Charitable Gifts”, by Terrance S. Carter and Theresa L.M. Man, presented to the Society of Estate and Trust Practitioners on March 4, 2004, available at <http://www.carters.ca/pub/article/charity/2004/tsc0304.pdf>.

²⁶ Minister of Finance, *Legislative Proposals, Draft Regulations and Explanatory Notes Relating to Income Tax*, September 16, 2004.

a) Taxation of Gross Revenue

Gross revenue generated by a registered charity from prohibited activities will be taxed at rates between 5%, for first infractions, and up to 100% for repeat infractions, for private foundations carrying on a business activity, charitable organizations and public foundations carrying on an unrelated business activity, and foundations that acquire control of a corporation through means other than those allowed under the ITA.

b) Suspension of Tax Receipting Privileges

Registered charity tax receipting privileges will be suspended for improper diversions of charitable assets and for failure to comply with certain verification and enforcement sections of the ITA, such as keeping books and records. Where a registered charity provides undue benefits to “any person,” including “trustees,” not only will the tax receipting privileges be suspended for a repeat infraction, but there will also be the imposition of a 105% tax for a first infraction and 110% tax for a second infraction on the amount of the undue benefit. This means that directors of charities will become obligated to ensure that the salaries paid to its employees, particularly its chief operating officers (including, in the event of churches, its pastors and ministers) is reasonable in the circumstances. Charities will be advised to prudently conduct a comparison in salaries for all staff and contract workers. However, it will be necessary to carefully review the specific wording of the enabling legislation before making a determination in this regard.

c) Monetary Penalties

The 2004 Budget imposes monetary penalties of \$500 for failure to file annual information returns, together with the publication of the names of late or non-filers.

d) Tax on Gifts and Transfers to Other Registered Charities

A 125% tax will be imposed on the stated eligible amount of a gift if there is, in fact, no gift or if the receipt contains false information. In addition, if such receipt exceeds \$20,000, then tax the charity's receipting privileges will be suspended. Where a registered charity issues receipts with incomplete information, there will be a 5% penalty on the eligible amount stated on the receipt for a first infraction, and a 10% penalty on repeat infractions. In addition, where a charity is involved in delaying the expenditure of money on charitable activities by transferring the funds to another registered charity, both charities involved will be jointly and severally liable for the amounts so transferred, together with a 10% tax on such amounts. In situations where a gift is one that is restricted under subsections 149.1(2), (3), or (4) of the ITA, there will be a 105% tax on the amount of the gift for a first infraction, and a 110% tax on repeat infractions.

The following chart is included in the 2004 Budget to provide specifics of the infraction in question, together with taxes and penalties that apply for both first infractions and repeat infractions:

| Infraction | Tax or Penalty (Unless registration of the charity is revoked) | |
|--|--|--|
| | First infraction | Repeat infraction (Repeated acts or omissions will increase the probability of revocation) |
| Late filing of annual information return | \$500 penalty | \$500 penalty |
| Issuing of receipts with incomplete information | 5% penalty on the eligible amount stated on the receipt | 10% penalty on the eligible amount stated on the receipt |
| Failure to comply with certain verification and enforcement sections of the Income Tax Act (230 to 2315), eg keeping proper books and records | Suspension of tax-receipting privileges | Suspension of tax-receipting privileges |
| Charitable organization or public foundation carrying on an unrelated business | 5% tax on gross unrelated business revenue earned in a taxation year | 100% tax on gross unrelated business revenue earned in a taxation year and suspension of tax-receipting privileges |
| Private foundation carrying on any business | 5% tax on gross business revenue earned in a taxation year | 100% tax on gross business revenue earned in a taxation year, and suspension of tax-receipting privileges |
| Foundation acquires control of a corporation | 5% tax on dividends paid to the charity by the corporation | 100% tax on dividends paid to the charity by the corporation |
| Undue personal benefit provided by a charity to any person. For example, a transfer to a person who does not deal at arm's length with the charity or who is the beneficiary of a transfer because of a special relationship with a donor or a charity | 105% tax on the amount of undue benefit | 110% tax on the amount of undue benefit and suspension of tax-receipting privileges |
| A gift that is restricted under subsections 149.1(2), (3) or (4) of the Act | 105% tax on the amount of the gift | 110% tax on the amount of the gift |
| Issuing receipts in a taxation year for eligible amounts that in total do not exceed \$20,000 if there is no gift or if the receipt contains false information | 125% tax on the eligible amount stated on the receipt | 125% tax on the eligible amount stated on the receipt |
| Issuing receipts in a taxation year for eligible amounts that in total exceed \$20,000, if there is no gift or if the receipt or if the receipt contains false information | Suspension of tax-receipting privileges and 125% tax on the eligible amount stated on the receipt | Suspension of tax-receipting privileges and 125% tax on the eligible amount stated on the receipt |
| Delaying expenditure of amounts on charitable activities through the transfer of funds to another registered charity | The charities involved are jointly and severally, or solidarily, liable for the amounts so transferred plus a 10% tax on those amounts | The charities involved are jointly and severally, or solidarily, liable for the amounts so transferred plus a 10% tax on those amounts |

| Infraction | Tax or Penalty (Unless registration of the charity is revoked) | |
|---|---|---|
| | First infraction | Repeat infraction (Repeated acts or omissions will increase the probability of revocation) |
| <p>Notes:</p> <p>These intermediate sanctions will not prevent application of the current provisions, which allow the Minister of National Revenue to revoke the registration of a charity in respect of any of the above infractions. For example, failure to file an information return may result in revocation of registered status upon a first infraction. This chart does not include infractions for which no tax or penalty would be assessed, yet which would lead to revocation, e.g. ceasing to conduct charitable activities.</p> <p>Taxes and penalties will be assessed in aggregate for a taxation year.</p> <p>A repeat infraction is an action in a taxation year that gives rise to a tax or penalty in respect of which an assessment was previously raised for a preceding taxation year.</p> <p>Rules of general application may also apply in addition to the sanctions referred to above, e.g. the failure to keep proper books and records is an offence punishable by a fine or imprisonment.</p> | | |

2. Transfer of Amounts in Respect of Taxes and Penalties

Where a charity is required to pay taxes or penalties which total more than \$1,000 in a particular taxation year, the charity will be permitted to transfer such amount to eligible donees that satisfy all of the following conditions:

- the donee is not subject to any tax, penalty or suspension, etc. under the ITA;
- the donee is not subject to a certificate pursuant to the *Charities Registration (Security Information) Act*²⁷ (i.e. a part of the *Anti-terrorism Act*); and
- the donee is a registered charity with more than 50% of the members of its board of directors dealing at arm's length with each member of the board of directors of the charity that is subject to the tax penalty.

²⁷ S.C. 2001, c. 41.

3. Revocation and Annulment

The Minister retains the right to revoke the registered status of a charity in the event of severe breaches of the ITA, including where the organization is being operated for non-charitable purposes or where an organization obtained its registration on the basis of false or deliberately misleading information. The 2004 Budget also requires that the assets of a registered charity whose charitable status has been revoked can only be transferred to “eligible donees” referred to above, rather than to the full list of qualified donees, such as municipalities or foreign universities. Should the Minister believe that charitable assets are being diverted or directed for private benefit, CRA can obtain a judge’s authorization to commence collection proceedings against a charity immediately after revocation, instead of waiting for the normal expiration of one year from the date of revocation.

The 2004 Budget will provide the Minister with explicit authority to annul the registration of an organization registered in error. The benefit of an annulment is that the normal 100% Part V revocation tax will not apply. As well, official receipts issued prior to annulment will be honoured.

The new measures in relation to annulment, as well as revocation, will apply to notices issued by the Minister after the later of December 31, 2004 and 30 days after Royal Assent to any measures giving effect to this proposal.

4. Appeals Regime

The 2004 Budget attempts to make the appeal process more accessible and affordable for registered charities and successful applicants for charitable status than has been the case in the past.

a) Internal Reconsideration Process

The 2004 Budget proposes to extend the application of CRA's existing internal objection review process to notices of a decision regarding denial of applications for charitable status, revocation or annulments of a charity's registration, designation of a charity as a private or public foundation or charitable organization, and the imposition of any taxes or penalties against a registered charity.

An organization that wishes to avail itself of the internal reconsideration process will be required to file a notice of objection within 90 days from CRA's issuance of the impugned notice. The results of the review will be communicated in writing and no appeal can be made to a court unless the objection process has been employed.

b) External Appeals Process

The Federal Court of Appeal retains jurisdiction to hear appeals from CRA's decisions concerning refusal to grant registered charitable status or revocation of registered charitable status. This is unfortunate, as an appeal in this regard is a very costly process that few charities can afford to pursue. Appeals of decisions to annul the registration status of a charity will also be directed to the Federal Court of Appeal.

Tax and penalty appeals will be directed to the Tax Court of Canada.

The new objection and appeal process will not apply to an applicant or registered charity that is subject to a certificate under the *Charities Registration (Security Information) Act*.

This new internal reconsideration process, as well as the external appeals process will apply to notices of decisions that are issued by the Minister after the later of December 31, 2004 and 30 days after Royal Assent to any measure giving effect to this proposal.

E. CIVIL PENALTIES FOR MISREPRESENTATION OF TAX MATTERS BY THIRD PARTIES

The Federal Government proposed civil penalties for misrepresentation of tax matters by third parties as part of its Federal Budget in February 1999, which quickly became the subject matter of much debate amongst tax professionals. Section 163.2 of the *ITA* was introduced in June 2000, providing a new civil penalty for third parties, which was aimed at tax preparers, advisors, tax shelter promoters and valuers who cause others to misrepresent the taxes owed. There are two separate penalties, which were explained by CRA in *Information Circular IC 01-1* at 2.²⁸

Both section 163.2 of the *ITA* and section 285.1 of the *ETA* provide for two penalties, one directed primarily at those who prepare (or participate in), sell or promote a tax shelter or tax shelter-like arrangement, and the other directed at those who provide tax-related services to a taxpayer. The first of these two penalties will be referred to as the “planner penalty” and the latter will be referred to as the “preparer penalty”... .

CRA’s Fact Sheet dated November 2002 concerning art-donation or art-flipping schemes indicates that the third-party penalty can include charities that receive the donation if “it knows –

²⁸ Available at <http://www.cra-arc.gc.ca/E/pub/tp/ic01-1/ic01-1-e.pdf>.

or if it can reasonably be expected to have known – that the appraised value were incorrect.”
CRA’s position is confirmed in *Registered Charities Newsletter* No. 16.²⁹

In this regard, *Information Circular* IC 01-1 specifically indicates the following at 14:

If the charity knew, or would have reasonably been expected to know but for circumstances amounting to culpable conduct, that the valuations were incorrect, it would be liable for the penalties for issuing false receipts.

Even though the penalties imposed by section 163.2 on tax advisors who become involved in making false statements or submissions in relation to tax matters has been softened somewhat by replacing a “gross negligence” standard in the proposed legislation with a more moderate “culpable conduct test,” the extent of the resulting liability is not limited to tax professionals or tax advisors only. It also encompasses professional fundraisers and any individuals who are involved directly or indirectly in giving tax advice. This would include individuals who advise on the tax implication of making a charitable donation, which in many situations will include fundraisers. It could also include a charity’s volunteers who may have suggested that there is a tax advantage involved in a particular type of gift by a donor when there is not.

Section 163.2 also applies to advice given on the Internet through the website of a charity, whether the advice is in a “static” written form or involves an exchange back and forth between a representative of the charity and the donor, whether the representative is a professional fundraiser, employee of the charity, or a volunteer of the charity. As a result, section 163.2 of the *ITA* will need to be carefully studied by fundraisers, charities, and their boards of directors to ensure that there is compliance with this recent change.

²⁹ Available at <http://www.cra-arc.gc.ca/E/pub/tg/charitiesnews-16/charitiesnews16-e.pdf>.

F. AVOIDING LIABILITY INVOLVING DONOR RESTRICTED CHARITABLE GIFTS³⁰

One of the greatest areas of misuse of charitable assets involves the misapplication and misunderstanding of donor restricted charitable gifts.

In comparison, an unrestricted charitable gift is a gift given to further the charity's general charitable purposes and is not subject to any restrictions or limitations imposed by the donor. Accordingly, the charity's board of directors can use the gift to pursue any of the charity's general charitable purposes as authorized in its constating documents. Such funds are often referred to as "board designated funds" or "internally restricted funds." This is to be contrasted with a donor restricted charitable gift, which is a gift for a charitable purpose that is subject to certain binding restrictions, conditions, or limitations imposed by the donor, either directly or indirectly. The restrictions must be complied with, except where it is void as being contrary to public policy or where varied by a court order, failing which the board of directors of a charity may be found in breach of trust. A donor restricted charitable gift generally employs a charitable trust, which constitutes "a charity within a charity." Although it is beyond the scope of this paper to provide a detailed discussion of the legal issues involved in donor restricted charitable gifts, the following is a brief summary of some of those issues.³¹

³⁰ This portion of the paper was previously published in "'Looking a Gift Horse in the Mouth' – Avoiding Liability in Charitable Fundraising", by Terrance S. Carter, presented to the Canadian Association of Gift Planners, April 16, 2004, also available at www.charitylaw.ca

³¹ For a more complete discussion of the legal issues involving donor restricted charitable gifts, see "Donor Restricted Charitable Gifts: A Practical Overview Revisited", by Terrance S. Carter in *The Philanthropist*, Vol. 18, No. 1 (September 2003) and Vol. 18, No. 2 (December 2003).

1. Instances of Breach of Trust Involving Donor Restricted Charitable Gifts

Breach of trust case law involving donor restricted charitable gifts has been well established in both England³² and Canada.³³ Scenarios for which courts have found a breach of trust involving donor restricted charitable gifts include:³⁴

- diverting funds intended for one charitable program for use in another charitable program. For example, a charity using monies from an estate that was intended by the testator to help the poor in one parish by diverting those monies to help the poor in another parish;
- withholding a fund and not applying them to the purpose for which they were intended;
- concealing the existence of a charitable trust fund from the persons or groups intended to benefit from it;
- placing funds into a perpetual endowment fund when all funds were intended to be expended in the short term in support of a particular operational program of the charity;
- mixing funds with another charity and then applying the combined funds for the purposes of the other charity;

³² See J. Warburton and D. Morris, eds., *Tudor on Charities*, 8th ed. London: Suite & Maxwell, 1995 at 245 [Warburton & Morris] for list of applicable case law.

³³ See also *Young Women's Christian Association Extension Campaign Fund* [1934] 3 W.W.R. 49 (Sask. K.B.); *R. v. Baker* (1984), 11 D.L.R. (4th) 430, 47 O.R. (2d) 415, 17 E.T.R. 168 (Ont. S.C. (HCJ)).

³⁴ For an extensive list of case citations, see Warburton & Morris, *supra* note 29 at 245; and Hubert Picarda, *The Law and Practice Relating to Charities*, 2nd ed. (London: Butterworths, 1995), at p. 367.

- encroaching upon an endowment fund's capital that was intended to be held in perpetuity;
- using land received in trust to further a church's particular doctrine for the benefit of individuals adhering to a different doctrine;
- unilaterally attempting to alter the terms of a trust deed for property without first obtaining court authorization;
- borrowing monies from a donor restricted charitable trust fund notwithstanding that there was a *bona fide* intent to repay those monies together with interest;
- using surplus funds from a public fundraising appeal for different charitable purposes from those communicated in the public appeal without first obtaining court authorization; and
- altering the terms of a donor's restriction without first obtaining court authorization.

2. Can a Donor Restriction be Unilaterally Varied?

Many charities believe they have an inherent right to unilaterally vary the terms of a donor restriction or to liberally interpret the applicable restriction. Alternatively, many charities believe that the executor of an estate has an inherent ability to unilaterally vary or liberally interpret the donor's restrictions. Neither of these assumptions is correct. Only the courts, with their inherent scheme-making power, can vary the terms of a restricted special

purpose charitable trust requiring a charity to apply for a *cy pres* order. Anything less would likely constitute a breach of trust leading to liability for the charity and its board of directors. As noted in Warburton & Morris:

It is not for the trustees [of a charity] to deal with the funds on their own authority, even by the direction or approval of the original subscriber of the charitable funds.³⁵

Accordingly, in order to vary a donor restricted charitable gift, an application must be made to the court for a *cy pres* order. Any attempt to unilaterally vary a donor restricted charitable gift based solely upon the donor's consent would likely constitute a breach of trust and must therefore be carefully avoided notwithstanding the time and expense of making the necessary court application.

Two situations exist in which court approval may not be necessary. The first situation is where the gift reverts back to the donor upon a *cy pres* application's failure. The second situation is where, due to the failure of either a condition precedent or a condition subsequent, there is a reversion back to the donor.³⁶ In both situations, the donor would be able to unilaterally reissue the gift to the intended charity, either with new restrictions without imposing any restrictions.

G. SANCTIONS AND PENALTIES UNDER THE *CHARITIES ACCOUNTING ACT* (ONTARIO)

In addition to third party civil penalties under the *ITA*, there is Ontario legislation which provides significant penalties and sanctions for charities and their directors who misapply charitable property. The *CAA* supplements the fiduciary duties placed upon directors to manage and protect

³⁵ Warburton & Morris, *ibid* at 245.

³⁶ See Carter *supra*, note 28 at 44-48 and 63-67 for a more detailed explanation of conditional gifts and the consequences flowing from non-fulfillment of conditions.

charitable assets by imposing statutory liability upon directors for their failure to do so. This imposition of liability is achieved by providing certain rights to donors of charitable property, the PGT and the public at large to call directors to account for their improper diversion of charitable assets.

The applicable provisions under the *CAA* are summarized below:³⁷

1. Section 6

Section 6 of the *CAA* allows a donor to make a complaint about the fundraising practices of a charity by simply delivering a written complaint to any judge of the Ontario Superior Court of Justice. The judge may then order an investigation by the PGT in the same manner as if the PGT were conducting a public inquiry under the *Public Inquiries Act*. In this regard, subsections 6 (1) and (2) of the *CAA* provide for the following procedures:

6(1) - Any person may complain as to the manner in which a person or organization has solicited or procured funds by way of contribution or gift from the public for any purpose, or as to the manner in which any such funds have been dealt with or disposed of.

6(2) - Every such complaint shall be in writing and delivered by the complainant to a judge of the Superior Court of Justice.

Subsection 6(6) of the *CAA* states that the PGT's report concerning the investigation is to be given in writing to the judge who ordered the investigation and the Attorney General of Ontario. Under subsection 6(7), a judge may then order a passing of accounts of the charity under investigation. Subsection 6(8), though, states that the right to complain to a judge

³⁷ For a more detailed discussion on directors statutory duties under the *Charities Accounting Act*, see Terrance S. Carter, "Looking a Gift Horse in the Mouth", paper prepared for the Osgoode Hall Law School Professional Development Program, 2000), also available at www.charitylaw.ca.

about the charity’s fundraising practice does not apply to a “religious or fraternal organization.”³⁸

2. Section 10

Subsection 10(1) of the *CAA* provides a mechanism whereby two or more people can allege a breach of trust involving a charitable purpose and may apply to the Ontario Superior Court of Justice for an order or direction as the court considers just, including an order for an investigation by the PGT. Such investigation could lead to a demand for a formal passing of accounts by the charity under section 3 of the *CAA*, as well as an order under subsection 4(d) of the *CAA* to enforce donor directions as explained below.

3. Subsection 4(d)

A complaint concerning a charity’s fundraising practices could result in the PGT seeking an order under subsection 4(d) of the *CAA* that would indirectly cause a review of the fundraising practices of the charity. In this regard, section 4 of the *CAA* provides a mechanism that allows the PGT to obtain a court order, amongst other remedies, to enforce directions established by a donor in making a charitable gift.

The relevant wording of section 4 of the *CAA* is set out below as follows:

³⁸ For more judicial discussions concerning the impact of s.6 of the *Charities Accounting Act*, see *Stahl v. Ontario Society for the Prevention of Cruelty to Animals* (1980), 70 O.R. (2d) 355 (Dist. Ct.); *Boldrini v. Hamilton Naturalists’ Club* (1995), 58 A.C.W.S. (3d) 1047, [1995] O.J. No. 3321 (Gen. Div.). For commentary of these cases, see Terrance S. Carter, “Advising the Charitable Client: Pro-active Legal Risk Management Advice” in *Law Society of Upper Canada Special Lecture Series 1996, Estate Planning, Administration and Litigation* (Toronto: Carswell, 1996), also available at www.charitylaw.ca.

Section 4 - If any such executive or trustee,...

(d) is not applying any property, fund or money in the manner directed by the will or instrument, ...

a judge of the Superior Court of Justice upon the application of the Public Trustee, may make an order,

(e) directing the executor or trustee to do forthwith or within the time stated in the order anything that the executor or trustee has refused or neglected to do in compliance with Section 1, 2 or 3, or with regulations made under this Act; ...

(g) removing such executor or trustee and appointing some other person to act in the executor's, or trustee's stead;...

(j) giving such directions as to the future investment, disposition and application of any such property, funds or money as the judge considers just and best calculated to carry out the intentions of the testator or donor; ...

(k) imposing a penalty by way of fine or imprisonment not exceeding twelve months upon the executor or trustee for any such default or misconduct or for disobedience to any order made under this section...
[Emphasis added]

The procedure set out in section 4 of the CAA means that if a charity fails to comply with a direction by a testator in a will or by a donor in a written instrument, then the PGT, either on its own initiative or as a result of a complaint received from a donor or anyone else, has the ability to bring the matter before the court to request that the charity be removed as the trustee of the directed fund and that a new trustee be appointed. Alternatively, the PGT could request that the court require the charity to comply with the terms of the directions given by the donor, as well as possibly impose a penalty or even imprisonment on the charity or its directors.

4. Section 3

Under section 3 of the CAA, if a donor makes a complaint to the PGT concerning a fundraising practice of a charity or a misapplication of directed funds, the PGT has the statutory right to require a charity to submit its accounts for a formal passing of accounts before a judge. The relevant wording of section 3 of the CAA sets out the following procedures:

3 - Whenever required so to do by the Public Guardian and Trustee, an executor or trustee shall submit the accounts of dealings with property coming into the hands or under the control of the executor or trustee under the terms of the bequest or gift to be passed and examined and audited by a judge of the Superior Court of Justice.

The requirement for a formal passing of accounts could then result in the court issuing an order under section 4 of the CAA.

H. CONCLUSION

This paper, in conjunction with the accompanying article on anti-terrorism and charities, has attempted to provide the reader with a general overview of some of the more significant sanctions and enforcement that are utilized in Canada to protect against the diversion of charitable assets. The legal landscape in Canada in this regard is an evolving state towards more sanctions and enforcement and will likely continue to do so in the foreseeable future.

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