Occasional Paper

Direction and Control: Current Regime and Alternatives

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The Pemsel Case
FOUNDATION

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"The law of charity is a moving subject"
– Lord Wilberforce

About Us

Named after the 1891 House of Lords decision, *Commissioners for Special Purposes of the Income Tax v. Pemsel*, [1891] A.C. 531, which established the four principal common law heads of charity used in Canada and elsewhere, The Pemsel Case Foundation is mandated to undertake research, education and litigation interventions to help clarify and develop the law related to Canadian charities. The Pemsel Case Foundation is incorporated under the Alberta *Societies Act* and is a registered charity.

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Table of Contents

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1. Introduction

For many years, the charitable sector has pointed out that the Canadian regulatory regime has made it extremely difficult for registered charities to engage in international charitable work or work in Canada with non-qualified donees. To do so, charities are required to structure the activities in a cumbersome, contorted manner in order to fit within the Canada Revenue Agency's ("CRA") interpretation of the "own activities" test in the *Income Tax Act* ("ITA") and CRA's policy requiring charities to exercise direction and control over those activities. The Canadian regulatory regime in this regard is unique when compared to other jurisdictions globally in that it is the most onerous and at times impractical to comply with. This difficulty is compounded with uncertainty concerning what charities are required to do in order to comply with these requirements. Although CRA's policies differ in some manner in relation to what charities are required to do in order to comply with the requirements and what they are recommended to do, not implementing the recommended mechanisms often lead to problematic outcomes on CRA audits.

This paper reviews the current direction and control regime, and explores potential new approaches to regulatory oversight in this area by proposing changes to the legislation and CRA's polices. Particular focus is given to the examination of the U.S. expenditure responsibility approach as one alternative for overseeing transactions/projects that are currently subject to the Canadian direction and control regulatory regime. It is hoped that this review will inform the sector and policy makers on the need for reform of the direction and control regime and its replacement with an alternative approach that is both practical and sensitive to how charities operate both internationally and in Canada when working with third parties to achieve their charitable purposes.

The authors wish to explain that an ideal solution for the charitable sector in this regard would be to undertake a thorough revamp of the income tax regime governing registered charities to come up with a modern, coherent and empowering framework, including an efficient mechanism for charities to engage in international charitable work or work in Canada with non-qualified donees. However, such a reform would likely take years to accomplish. Instead, it is hoped that the proposed changes suggested in this paper would require as little legislative changes as possible, in providing an interim practical solution to the dilemma faced by charities, while leaving the broader restructuring of the framework to be accomplished at a later time.

It is interesting to note that the final report, *Catalyst for Change: A Roadmap to a Stronger Charitable Sector* ("Senate Report"), of the Special Senate Committee on the Charitable Sector ("Committee"), released on June 20, 2019, noted challenges relating to the own activities/direction and control requirement that were expressed by witnesses before the Committee hearing and submissions made to the Committee.[1] In particular, the direction

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[1] Canada, special Senate Committee on the Charitable Sector, *Catalyst for Change: A Roadmap to a Stronger Charitable Sector,* (Final Report), (Ottawa: Senate of Canada, June 2019), online: <sencanada.ca/content/sen/committee/421/CSSB/Reports/CSSB_Report_Final_e.pdf> ["Report"]. The Committee set out in

and control requirement was reported to be a serious obstacle for charities that operate as a part of an international network, given that Canadian charities are not always the dominant partner and cannot actually exercise the direction and control as required by CRA. Other reported difficulties include high compliance costs and uncertainty concerning whether compliance is achieved, as well as the fact that it does not align with contemporary international development values or Canadian international development policy.[2] In response, the Report recommends that CRA revise its Guidance CG-002, *Canadian registered charities carrying out activities outside Canada,* to replace the direction and control mechanism to careful monitoring through the implementation of an "expenditure responsibility test."[3]

2. ITA Provisions – Own Activities

A review of the direction and control requirements will require a review of the legislative basis for this CRA policy and in particular an understanding of a historical framework giving rise to the "own activity test' in the ITA.

(a) *Current ITA Provisions*

There is no requirement in the ITA for charities to exercise direction and control on their activities. This is an administrative policy of CRA based on an interpretation on the ITA requirement that charities operate their "own activities" when not making gifts to qualified donees.

There are three types of registered charities under the ITA, namely charitable organizations, public foundations and private foundations. The designation of a charity depends primarily on its structure, its source of funding and the mode of operation. The following are relevant ITA provisions in this regard:

- Charitable organizations are required, among other criteria, to ensure "all the resources of which are devoted to *charitable activities carried on by the organization itself*"[4] [emphasis added]. Charitable organizations are also required, as a result of Bill C-86, being the budget implementation legislation for the 2018 Federal Budget, to be "constituted and operated exclusively for *charitable purposes*" in line with the existing definition for charitable foundations (see below)[5] [emphasis added].
- Charitable foundations (which include public foundations and private foundations) are "constituted and operated exclusively for *charitable purposes*, …, and that is not a charitable organization"[6] [emphasis added].

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the Report its findings from a year-long study with respect to the charitable and non-profit sector and made 42 recommendations to the Government of Canada. The Report is intended to provide a "roadmap to ensure that genuine change is delivered so that the sector can reach from great to exceptional," as well as a "roadmap to a stronger and brighter future for the sector." See Terrance S Carter, Theresa LM Man & Ryan M Prendergast, "Special Senate Committee On Charitable Sector Releases Final Report" (27 June 2019), Charity & NFP Law Bulletin No. 451, online: Carters Professional Corporation <http://www.carters.ca/pub/bulletin/charity/2019/chylb451.pdf>.

[2] *Ibid* at 95.

[3] *Ibid,* Recommendation 30 at 97.

[4] *Income Tax Act*, RSC 1985 c 1 (5th Supp), s 149.1(1), definition for "charitable organizations" [ITA].

[5] *Ibid*. See also Bill C-86, *Budget Implementation Act, 2018, No. 2*, 1st Sess, 42nd Parl, 2019 (assented to 13 December 2018), Part I, s 17.

[6] *Ibid*, definition for "charitable foundations".

- The words "charitable purposes" in relation to both charitable organizations and charitable foundations "includes the disbursement of funds to a qualified donee".[7] However, the words "constituted and operated exclusively for charitable purposes" donot include devoting any "resources to the direct or indirect support of, or opposition to, any political party or candidate for public office"[8] [emphasis added].

- Charitable organizations are considered to have "devoted to charitable activities carried on by the organization itself" if they disburse not more than 50% of their income in each year to qualified donees.[9] As well, disbursements to qualified donees that are not paid out of the income of a charitable organization are deemed to be a devotion of the charitable organization's resources to a charitable activity carried on by it.[10]
- The charitable status of charitable organizations and charitable foundations may be revoked if the charity "makes a disbursement by way of a gift, other than a gift made (i) in the course of charitable activities carried on by it, or (ii) to a donee that is a qualified donee at the time of the gift."[11]

The above ITA provisions are generally interpreted to mean that a registered charity can only use its resources in two ways, whether inside or outside Canada: on their own activities and on gifts to qualified donees. Specifically, charitable organizations are required to primarily carry on their own charitable activities and may, if they wish, disburse not more than 50% of their income annually to qualified donees. The requirement that charitable organizations must devote all of their resources to "charitable activities carried on by the organization itself" is interpreted by CRA to mean that they have to conduct their own activities, and thereby is often referred to as the "own activities" test.

Public foundations are required to give more than 50% of their income annually to other qualified donees but, provided that the threshold is met, may also carry on charitable activities.[12] Private foundations, however, may carry on their own charitable activities and may disburse funds to qualified donees without restriction.[13]

(b) *Historical Legislative Framework*

Historically, the requirement that "all the resources" of a charitable organization be "devoted

[7] *Ibid*, definition for "charitable purposes".

[8] *Ibid*, s 149.1(6.1) regarding charitable organizations; s 149.1(6.2) regarding charitable foundations.

[9] *Ibid*, s 149.1(6)(b).

[10] *Ibid*, s 149.1(10).

[11] Parallel versions of this provision apply to charitable organizations, public foundations and private foundations in ss 149.1(2)(c), (3)(b.1) and (4)(b.1) of the ITA, *ibid*.

[12] Canada Revenue Agency, "Types of registered charities (designations)" (last modified 9 April 2019), online: <www.canada.ca/en/revenue-agency/services/charities-giving/charities/applying-registration/types-registered-charities-designations.html>. There is no explicit requirement in the ITA that public foundations must disbursed more than 50% of their income annually to qualified donees. Since the ITA prohibits charitable organizations from disbursing more than 50% of their income annually to qualified donees and the ITA provides that a charitable foundation is not a charitable organization, CRA takes the administrative position that public foundations must disburse at least 50% of their income to qualified donees.

[13] It is not clear from the ITA whether there is any requirement on private foundations to give more than 50% of their income annually to qualified donees. CRA takes the administrative position that the language in the definition for "charitable foundation" implies that public foundations must disburse at least 50% of their income to qualified donees. CRA therefore also takes the administrative position that the definition for "private foundation" in s 149.1(1) of the ITA indicating that a private foundation is a charitable foundation that is *not* a public foundation means that private foundations are not required to give at least 50% of their income annually to other qualified donees.

to charitable activities carried on the by the organization itself" has remained the same since 1950 despite various amendments to the ITA over the years. The requirement that foundations be constituted and operated for charitable purposes also stems from wording that was put in place in 1950.

Before 1950, the *Income War Tax Act*,[14] enacted in 1917, provided that the income of "religious, charitable, agricultural and education institutions" were exempt from tax. In 1948, in order to ensure that "all organizations that were charitable according to the common-law definition be eligible for the exemption,"[15] the applicable section of the legislation was amended to refer to these institutions as "charitable organizations" when the *Income War Tax Act* was replaced by the *Income Tax Act.*[16]

In 1950, for the first time, charities were divided into charitable organizations, charitable [non-profit] corporations, and charitable trusts.[17] In this regard, a charitable organization was one where "all the resources of which were devoted to charitable activities carried on by the organization itself", but was prohibited from making gifts to charitable corporations or charitable trusts. A charitable corporation was required to be "constituted exclusively for charitable purposes", while a charitable trust was required to be a trust where "all of the property of which is held absolutely in trust for charitable purposes." Charitable corporations were required to disburse 90% of their income on charitable activities carried on by themselves, or by making gifts to other charitable organizations, charitable foundations, or the federal, provincial, or municipal government; while charitable trusts were required to disburse 90% of their income on "expenditure in respect of charitable activities", or by making gifts to other charitable organizations, charitable foundations.

It has been observed that the regime in 1950 was intended to "prevent charitable organizations from funding charitable non-profits and charitable trusts, and presumably from circulating funds endlessly or sheltering them without actually using them for charitable relief."[18] The regime meant that "if any part of the funds of the organization are distributed to other institutions or organizations which carry on charitable activities, the distributing organization will not qualify" as a charitable organization.[19]

There were minor changes in the ITA in the early 1970s that broadened how charitable corporations and charitable trusts could disburse their funds, while the definition for charitable organization remained the same. One author, when commenting on charitable organizations at the time, indicated that "[o]ne of the essential elements that distinguishes this type of organization is that the activity carried on must be carried on by the organization itself, that is,

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[14] *Income War Tax Act, 1917*, 7-8 Geo 5, c 28 (Can), s 5(d).

[15] Ontario Law Reform Commission, *Report of the Law of Charities* (Toronto: Ontario Law Reform Commission, 1996) at 630 ["OLRC Report"] at 257.

[16] *Income Tax Act*, SC 1947-48, c 52 (Can).

[17] *An Act to Amend the Income Tax Act*, SC 1950, c 40. See "Bill No. 177 (to amend the Income Tax Act)", 2nd reading, *House of Commons* Debates, 21-2, No 3 (18 May 1950) at 2617-21. See also Department of National Revenue, Information Circular 73-11 "Registered Canadian Charitable Organizations" (14 May 1973).

[18] Carl Juneau, "The Canadian Income Tax Act and the Concepts of Charitable Purposes and Activities" (2016) The Pemsel Case Foundation Occasional Paper at 4-5, online: <https://thephilanthropist.ca/2016/10/the-canadian-income-tax-act-and-the-concepts-of-charitable-purposes-and-activities/>.

[19] R Appleby, "The Taxation of Charitable Institutions" (1973), 1:2 Philanthropist 17 at 19.

directly under its supervision and control"[20] and that the "the legislation restricts the application of funds … to the exclusive use of them by the charitable organization in its own charitable activities" and therefore a charitable trust "which dispenses funds to other charitable organizations cannot itself qualify" as a charitable organization.[21] According to a speech by the then Director, Registration Division of the Department of National Revenue, the requirement that a "charitable organization devote all its revenues to charitable activities carried on by itself … prohibits gifts to another charitable organization."[22] On the flip side, the Royal Commission on Taxation (the "Carter Commission"), stated that charitable corporations and charitable trusts "may act as conduits for distributing funds to charitable organizations" while charitable organizations may not.[23] The Carter Commission also specifically noted that "[it] should be made clear that charitable organizations can carry on their work inside or outside Canada.[24]

The 1975 Discussion Paper explained that the requirement that charitable organizations are prohibited from using their funds to fund another charity was because "this would detract from their role in carrying on direct charitable activities". It also explained that "most charitable corporations and charitable trusts are fund raisers, transferring the money raised or earned to other charities" and "most direct charitable activity is carried on by charitable organizations" is a matter of "practice … developed in Canada over the years."[25]

The categorization of registered charities was amended in 1976 whereby charitable [non-profit] corporations and charitable trusts morphed into "charitable foundations" similar to the current ITA regime. Charitable organizations continued to be required to devote all of their resources to charitable activities they carry on themselves. It was observed in 1976, prior to the amendment, that over 90% of the charities were classified as charitable organizations, and "[since] a transfer of money to another charity was not considered to be a chartable activity carried on by the charity itself, some charitable organizations obviously had difficulties in complying with the rule."[26] To address this problem, the ITA was amended in 1976 to allow charitable organizations to distribute up to 50% of their annual income to other registered charities and other entities that are similar to qualified donees today. The 1975 Discussion Paper pointed out that the 50% limit on distribution was designed to maintain a distinction between registered charities which essentially carry on their activities directly (charitable organization) and those which are essentially distributors of funds (charitable foundations)" where "the distinction continues to be necessary because charitable organizations are subject to significantly less control under the new proposals than charitable foundations."[27]

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[20] JG Smith, "Taxation of Charitable Organizations Under the Income Tax Act" in Report of the Proceedings of the Twenty-fifth Tax Conference, 1973 (Toronto: Canadian Tax Foundation, 1973) 160 at 168.

[21] *Ibid* at 170.

[22] EA Chater, "Administrative Aspects of the Taxation of Charitable Organizations Under the Income Tax Act" in Report of the Proceedings of the Twenty-fifth Tax Conference, 1973 (Toronto: Canadian Tax Foundation, 1973) 176 at 179.

[23] Canada, *Report of the Royal Commission on Taxation*, vol 4 (Ottawa: Queen's Printer, 1966) at 131.

[24] *Ibid* at 134-135.

[25] Canada, Department of Finance, *The Tax Treatment of Charities* (Discussion Paper) (Ottawa: 23 June 1975) at paras 9, 11 ["1975 Discussion Paper"]. See also Canada, Department of Finance, *Budget Paper D: Charities under the Income Tax Act* (Ottawa: 25 May 1976).

[26] Faye L Woodman, "The Tax Treatment of Charities and Charitable Donations Since the Carter Commission: Tax Reform and Present Problems" (1988) 26 Osgoode Hall LJ 537 at 547.

[27] 1975 Discussion Paper*, supra* note 25 at para 12.

Lastly, the definition for "charitable organization" was amended as a result of the 2018 Federal Budget, requiring charitable organizations be "constituted and operated exclusively for charitable purposes" to align with the existing definition for charitable foundations. This amendment therefore enabled both charitable organizations and charitable foundations to be constituted and operated exclusively for charitable purposes. This amendment was made pursuant to Bill C-86, *Budget Implementation Act, 2018, No. 2* (which received Royal Assent on December 13, 2018) as part of a package of ITA amendments removing reference to political activities from the ITA (including the quantitative limits on nonpartisan political activities in particular) and instead introducing the concept of "public policy dialogue and development activities".[28]

(c) *Justification for "Own Activities" Requirement*

It is doubtful whether the historical basis or rationale for the requirement that charitable organizations must devote all their resources to charitable activities carried on by the organizations themselves continues to be valid in 2019, almost 70 years after the distinction between actively carrying on charitable activities and charitable funders was first entrenched in the ITA in 1950.

It was pointed out in the 1970s that the distinction between charitable organizations as carrying on their activities directly, and charitable foundations as distributors of funds was thought to be necessary because charitable organizations were subject to significantly less regulatory control than charitable foundations (at least in the 1970s).[29] However, the legislative regulatory regime on the three types of registered charities has become less distinct over the years with drastic changes having been made to the ITA on a number of occasions. Examples of sweeping changes include the implications of reforming the disbursement quota rules in 2010 so that charitable organizations and charitable foundations are now subject to basically the same disbursement requirements; as well as the amendment to the ITA in 2018 requiring both charitable organizations and charitable foundations be constituted and operated exclusively for charitable purposes. Today, it can hardly be said that charitable organizations are subject to significantly less regulatory control than public foundations, although private foundations are still subject to special additional rules, such as excess corporate holding limits and loan back rules.

In fact, as a result of the amendment to the ITA in 2018 requiring both charitable organizations and charitable foundations be constituted and operated exclusively for charitable purposes, it is doubtful whether there is still any need to retain the requirement in the ITA that charitable organizations devote all their resources to charitable activities. If a charitable organization is required to be constituted and operated exclusively for charitable purposes, it would, by implication, be required to carry on activities to further the charitable purposes. This aligns with the law in the *Vancouver Society of Immigrant and Visible Minority Women v. M.N.R*. case that the focus should be on whether a charity furthers its charitable purposes, not whether it carries on charitable activities.[30]

There was also an argument in 1975 that allowing charitable organizations to fund other charities "would detract from their role in carrying on direct charitable activities".[31] The merit of this

[28] Bill C-86, *supra* note 5.

[29] *Supra* note 27.

[30] *Vancouver Society of Immigrant and Visible Minority Women v MNR* (1999), 1 SCR 10. See also Juneau, *supra* note 18.

[31] *Supra* note 25.

argument today is doubtful. Both charitable organizations and charitable foundations may make gifts to qualified donees and also carry on direct charitable activities. If the ability to make gifts is not a distraction for charitable foundations, there is no reason why it would be the case for charitable organizations.

As well, requiring charitable organizations to devote all their resources to charitable activities carried on by the organizations themselves no longer serves any purpose in ensuring funds are so devoted in a timely manner. With the repeal of the 80% disbursement quota in 2010, charities (charitable organizations and charitable foundations alike) are no longer required to disburse funds within a certain time frame. The requirement to disburse funds under the 3.5% disbursement quota affects only a relatively small proportion of assets held by the charitable sector. Likewise, it is no longer valid that requiring charitable organizations to devote all their resources to charitable activities carried on by the organizations themselves would prevent them from being conduits for distributing funds to other charities and from "circulating funds endlessly or sheltering them without actually using them for charitable relief", something that was left to charitable foundations to do as fund raisers for other charities.[32]

Others have suggested that requiring charitable organizations to devote resources to their own activities would promote accountability by charities and promote trust in the sector. If this rationale was true, then there would be no accountability with respect to charitable foundations because they are not required to devote resources to their own activities. In fact, charitable foundations may disburse all of their funds to other charities.

Accountability does not rely on who operates an activity, it depends on how charitable assets are utilized to further a charitable purpose.

Similarly, evidence presented by the Department of Finance to the Senate of Canada Special Committee – Charitable Sector indicates that "the policy motivation underlying this general set of rules [for charities is] about ensuring proper functioning of the tax system, but also [ensuring] that donations are used for the purpose intended by policy" because charitable registration provides donors with three benefits: "having access to tax-receipted, tax-assisted charitable donations and favourable sales tax treatment."[33] Finance also explained that the regime in the ITA is to "ensure that when charities spend their money, they're spending their money on charitable things" by requiring "organization[s] to be carrying on the activity or, if they're going to give away their money, they give it away to other organizations that are qualified donees, which are socially beneficial organizations recognized by the government as being worthy of tax assistance."[34] While it is reasonable for the ITA to reflect the tax policy of ensuring charitable donations are used for the purpose intended by policy, there is a disconnect between requiring charities to either carry on their own activities or make gifts to qualified donees. It is also unreasonable to take the

[32] *Supra* note 18 and 23.

[33] Pierre Leblanc, Director General, Personal Income Tax Division, Tax Policy Branch, Department of Finance Canada (Oral submission delivered at the Proceedings of the Special Senate Committee on the Charitable Sector, Ottawa, 23 April 2018), transcript available online: <https://sencanada.ca/en/Content/Sen/Committee/421/CSSB/02ev-53971-e> .

[34] Blaine Langdon, Director, Charities, Personal Income Tax Division, Tax Policy Branch, Department of Finance Canada (Oral submission delivered at the Proceedings of the Special Senate Committee on the Charitable Sector, Ottawa, 1 April 2019), transcript available online: <https://sencanada.ca/en/Content/Sen/Committee/421/CSSB/54630-e> .

position that only qualified donees are "socially beneficial organizations recognized by the government as being worthy of tax assistance" while other charities outside Canada are not.[35]

Lastly, it is important to note that the ITA contemplates charitable organizations and charitable foundations needing to conduct charitable activities or making "gifts" to qualified donees. None of the ITA provisions over the years refer to making "grants." The distinction of grant making as opposed to making gifts, and how allowing grant making under the current ITA regime can be a solution to concerns over the "own activities" test and CRA's direction and control mechanism is discussed below.

3. CRA Policies – Direction and Control

This section of the paper reviews CRA policies on direction and control, a summary of the applicable case law addressing direction and control, as well as an overview of the difficulties encountered by the charitable sector in having to comply with CRA's policy on direction and control.

(a) *CRA Policies*

Currently, CRA's interpretation of the application of the ITA regime explained above are set out in two CRA policies, Guidance CG-002 Canadian Registered Charities Carrying Out Activities Outside Canada, in relation to how charities may carry on activities outside Canada ("CRA Foreign Activities Guidance"), and CRA's Guidance CG-004 Using an Intermediary to Carry out a Charity's Activities within Canada, in relation to how charities may carry on activities in Canada through intermediaries ("CRA Domestic Activities Guidance").[36] The requirements in these two guidance are essentially the same (collectively "Guidances").

These CRA Guidances set out CRA's administrative requirement of "direction and control" mechanism, based on its interpretation of the requirement in the ITA that charitable organizations devote all their resources "to charitable activities carried on by the organization itself."

Many in the sector have repeatedly expressed concerns with CRA's interpretation of the "own activities" test and the direction and control mechanism for years. Instead of addressing these concerns, CRA's requirements have become more and more onerous over the years. This can be seen from a comparison of CRA's requirements set out in the current CRA Foreign Activities Guidance and CRA Domestic Activities Guidance, which replaced Guide RC4106 in 2010, which in turn replaced Circular 80-10R dated December 17, 1985, in 2000.

It has been observed that the "direction and control" policy was "originally intended to create a suitable audit trail in the context of a legitimate agency agreement, in order to prevent Canadian charities from merely acting as conduits for foreign organizations, but it became more stringent in

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[35] *Ibid*.

[36] Canada Revenue Agency, Guidance CG-002, *Canadian Registered Charities Carrying Out Activities Outside Canada* (8 July 2010), s 1, online: <www.canada.ca/en/revenue-agency/services/charities-giving/charities/policies-guidance/guidance-002-canadian-registered-charities-carrying-activities-outside-canada.html)> ["CRA Foreign Activities Guidance"]; Canada Revenue Agency, Guidance CG-004, *Using an Intermediary to Carry out a Charity's Activities within Canada* (20 June 2011), s 1, online: <www.canada.ca/en/revenue-agency/services/charities-giving/charities/policies-guidance/using-intermediary-carry-a-charitys-activities-within-canada.html> ["CRA Domestic Activities Guidance"].

the wake of the 2001 World Trade Center terrorist attack and the 2006 Inquiry into the Air India bombing, out of concern that funds might be eventually find their way into questionable uses."[37]

Historically, CRA's administrative policy on direction and control was born out of persistent questioning by the charitable sector in the early 90s regarding what "own activities" meant. For example, early requirements on the "direction and control" mechanism expressed in Circular 80-10R dated December 17, 1985, was in rather simple terms.[38] It indicated that a charity may "administer its own charitable activities through an appointed agent or representative" provided that "(a) the charity must maintain direction, control and supervision over the application of its funds by the agent; (b) the charity's funds must remain apart from those of its agent so that the charity's role in any particular project or endeavour is separately identifiable as its own charitable activity; (c) the financial statements submitted in support of the charity's annual information returns must include a detailed breakdown of expenditures made in respect of the charitable activities performed on behalf of the charity by its agent(s); and (d) adequate books and records must be kept by the charity and its agent(s) to substantiate compliance with the conditions outlined above." It would appear at the time that the general common law standards on agency were acceptable as a mechanism to use in this context. However, it quickly became clear this somewhat superficial solution was not adequate.

The sector had expressed concerns in the 80s that CRA's regime did not "provide sufficient flexibility and protection from liability, and as a result Canadian charities are hindered in providing charitable assistance in other countries."[39] In this regard, CRA released a Discussion Paper in 1990[40] on various administrative practices and making charities more accountable. In response to the feedback from the sector, CRA indicated that in addition to agency, employee, and joint venture arrangements, it would also accept "performance contracts and other arrangements which secure expenditure responsibility by the Canadian charity" where "simplified arrangements [would] be developed in these circumstance to reduce the paper burden" on charities.[41] The Discussion Paper states as follows:

> The *Income Tax Act* does not distinguish between charitable activities in Canada and those carried on abroad. In other words, a Canadian charity may conduct its activities in Canada or elsewhere in the world.
>
> In doing so, a charity must demonstrate that all such activities are its own. Simply providing funds to a foreign organization is not sufficient.
>
> Administrative guidelines which outline ways that charities can meet this requirement have been published.

[37] Juneau, *supra* note 18 at footnote 2.

[38] Canada Revenue Agency, Circular 80-10R, *Registered Charities: Operating a Registered Charity* (17 December 1985). This Circular canceled and replaced Information Circular 80-10 (29 August 1980), and was later replaced by RC4108, *Registered Charities and the Income Tax Act* (June 2000).

[39] Canada Revenue Agency, *A Better Tax Administration in Support of Charities* (Discussion Paper) (Ottawa: 1990).

[40] *Ibid*. See also EB Bromley, "A Response to 'A Better Tax Administration in Support of Charities'" (1991) 10:3 Philanthropist 3.

[41] *Ibid*.

> Conditions attached to these arrangements provide adequate protection against possible abuse.
>
> It is acceptable for the foreign activities to be carried on by or through an agent or employee (as might be the case with a missionary), by another registered Canada charity, or through a joint venture.
>
> Leaders in the charity sector have pointed out that these arrangements do not always provide sufficient flexibility and protection from liability, and as a result Canadian charities are hindered in providing charitable assistance in other countries.
>
> The government will now accept other arrangements which ensure that charities are accountable for how their resources are used and introduce new controls to ensure public confidence is maintained in the foreign activities of Canadian charities.
>
> *Performance contracts and other arrangements which secure "expenditure responsibility" by the Canadian charity in an acceptable manner will now be allowed.* These arrangements will require specifically that charitable activities be carried out under the terms of a contract or arrangement. Acceptable joint venture agreement would include those with participation from the Canadian International Development Agency. *Simplified arrangements will be developed in these circumstances to reduce the paper burden.*
>
> Charities operating abroad will be closely monitored and be required to provide more detail in their annual returns on their financial involvement and how they will perform such activities.
>
> Improved information will also be made available to charities on how they may operate abroad.[42] [emphasis added]

The promised "expenditure responsibility" mechanism was never put in place. Instead of "reduc[ing] the paper burden" for charities by allowing Canadian charities to exercise "expenditure responsibility", CRA's requirements have become more onerous, restrictive and often impractical by replacing Circular 80-10R dated December 17, 1985, with a much more detailed regime in CRA's Guide RC4106, *Registered Charities and the Income Tax Act* in 2000.[43] Finally, RC4106 was replaced by the even more onerous requirements in 2010 with the current CRA Foreign Activities Guidance when charities work with intermediaries for activities outside of

[42] *Ibid*.

[43] Canada Revenue Agency, RC4108, Registered Charities and the Income Tax Act (2000).

Canada, and CRA Domestic Activities Guidance when charities work with intermediaries for activities in Canada.

In this regard, CRA's current Guidances take the position that the ITA provisions mean that "a registered charity can only use its resources (for example, funds, personnel, and property) in two ways, whether inside or outside Canada: on its own activities (those which are "directly *under the charity's control and supervision*, and for which it can account for any funds expended" [emphasis added]) and "on gifts to qualified donees."[44] In other words, there are two ways in which a charity may carry on its "own activities": (i) operate its "own" charitable activities by its employees, directors and/or volunteers, or (ii) operate its "own" charitable activities through intermediaries (such as an agent, a contractor, or any other body in a joint venture or partnership relationship).

These CRA Guidances also set out CRA's policy that making gifts to qualified donees is a passive process, where the funding charity does not need to exercise any direction and control. While the funding charity may impose restrictions on how the gift is to be used by the recipient qualified donee, this is neither an ITA requirement, nor required by CRA.

On the other hand, CRA's policies sets out onerous requirements on how a charity may utilize an intermediary, including the following highlights:

- CRA requires that the activities conducted by the intermediary must constitute the charity's "own activities (those which are directly under the charity's control and supervision, and for which it can account for any funds expended)". Charities are required to ensure that they "can distinguish [their] activities from those of the intermediary", in that charities "cannot simply pay the expenses an intermediary incurs to carry on the intermediary's own programs and activities."[45]
- CRA requires that a charity cannot merely be a conduit to funnel money to an organization that is not a qualified donee.[46]
- CRA requires the charity to "take all necessary measures to direct and control the use of its resources" when carrying out activities through an intermediary.[47]
- When carrying out activities through an intermediary, the following steps are "strongly recommended" by CRA; Create a written agreement, and implement its terms and provisions; communicate a clear, complete, and detailed description of the activity to the intermediary; monitor and supervise the activity; provide clear, complete, and detailed instructions to the intermediary on an ongoing basis; for agency relationships, segregate funds, as well as books and records; and make periodic transfers of resources, based on demonstrated performance.[48]

[44] CRA Foreign Activities Guidance and CRA Domestic Activities Guidance, *supra* note 36, s 1.

[45] CRA Domestic Activities Guidance, *ibid*, ss 1, 5.7.

[46] *Ibid*, s 1.1.

[47] *Ibid*, s 1.2.

[48] *Ibid*.

- CRA requires that the charity must maintain a record of steps taken to direct and control the use of its resources, as part of its own books and records, to allow CRA to verify that all of the charity's resources have been used for its "own activities."[49]
- Before deciding to work with an intermediary and during the course of any such arrangement, CRA provides that the charity "should" investigate its status and activities to assure itself that the "intermediary has the capacity (for example—personnel, experience, equipment) to carry out the charity's activity" and "there is a strong expectation the intermediary will use the charity's resources as directed by the charity."[50]
- CRA requires that the charity must be the "body that makes decisions and sets parameters on significant issues related to the activity on an ongoing basis", including "how the activity will be carried out, the activity's overall goals, the area or region where the activity is carried out, who benefits from the activity, what goods and services the charity's money will buy, when the activity will begin and end."[51]
- CRA "recommends" that a charity enter into a written agreement with any intermediary. However, CRA also indicates that signing an agreement is not enough to prove that a charity meets the own activities test because the charity must be able to show that the charity has a "real, ongoing, active relationship with its intermediary."[52]
- CRA states that "before starting an activity", the charity and its intermediary "should" agree on a clear, complete, and detailed description of the activity. The charity "should be able to document its exact nature, scope, and complexity" which includes detailed planning, such as exactly what the activity involves, its purpose, and the charitable benefit it provides; the precise locations in which the activity is carried on; a comprehensive budget for the activity, including payment schedules; a description of the deliverables, milestones, and performance benchmarks that are measured and reported; as well as the specific details concerning how the charity monitors the activity, the use of its resources, and the intermediary carrying on the activity.[53]
- CRA requires that the charity must exercise ongoing "monitoring and supervision" to allow the charity to make sure that its resources are being used for its "own activities", including "progress reports", "receipts for expenses and financial statements", "informal communication via telephone or email", "photographs", "audit reports" and "on-site inspections by the charity's staff members."[54]
- CRA requires that the charity must also provide "ongoing instruction" in order to provide necessary additional instructions or directions to an intermediary, which may include minutes of meetings or other written records of decisions, and to use written instructions

[49] *Ibid*.

[50] *Ibid*, s 4.

[51] *Ibid*, s 5.

[52] *Ibid*, s 5.2

[53] *Ibid*, s 5.3.

[54] *Ibid,* s 5.4.

(for example—letters, emails, or faxes) to communicate with an intermediary whenever possible.[55]

- CRA requires that the charity has the right to make periodic transfers by sending resources to an intermediary in instalments, based on demonstrated performance, rather than in one transfer; as well as the right to discontinue the transfer of money and have unused funds returned if it is not satisfied with the reporting, progress, or outcome of an activity.[56]
- The charity is also required by CRA to keep adequate books and records "in Canada" and CRA recommends that books and records be kept in either French or English.[57]
- While CRA acknowledges that the ITA does not require a charity to provide original source documents, such as receipts for purchases, to show that it is in compliance; nevertheless CRA "recommends that a charity get original source documents whenever possible, but acknowledges that war, natural disaster, lack of access to telephones or the Internet, low literacy rates, legal restrictions, or other conditions may make it impossible to do so." Therefore, CRA requires that where "getting original source documents may not be possible or practical", then the charity "should be able to explain why it cannot get them, and make all reasonable efforts to get copies and/or reports and records from staff and intermediaries to support its expenditures, and show that it has made such efforts. The charity will also have to show when, how, and in what amounts funds were transferred."[58]
- CRA indicates that for a charity that acquired land or buildings in another country, it can only transfer ownership to a non-qualified donee under three situations: "the country in which the charity is operating does not permit foreign ownership of capital property", "the capital property is transferred only as part of a development project to relieve poverty by helping a community to become self-sufficient", or "the charity can show that it has made every reasonable effort to gift the capital property to another qualified donee, and has made every reasonable effort to sell the capital property for its fair market value, but has not been successful."[59]
- CRA imposes the same requirements for the direction and control of resources to apply to charities that are offshoots of head bodies outside Canada. CRA acknowledges that it may not be practical to have the head body act as an intermediary for a charity, and thereby CRA "will probably consider" not requiring the charity to evidence direction and control if the charity transfers small amounts (the lesser of 5% of the charity's total expenditures in the year or $5,000) to a head body, and the charity has access to internationally produced material.[60]

[55] *Ibid,* s 5.5.

[56] *Ibid,* s 5.6.

[57] CRA Foreign Activities Guidance, *supra* note 44, s 8; CRA Domestic Activities Guidance, *ibid*, s 6.

[58] CRA Foreign Activities Guidance, *ibid,* s 8.1.

[59] *Ibid,* Appendix B.

[60] *Ibid*, Appendix C.

- CRA indicates four types of relationships that could be utilized – agency, contract for services, joint venture, and co-operative participant, setting out the terms of the agreement in accordance with various CRA requirements. The choice of which type of relationship to utilize will depend on the facts and the circumstances in each case.[61]

(b) *Canadian Caselaw Dealing with Direction and Control*

The issue of direction and control mechanism was reviewed by the Federal Court of Appeal in four cases – two in 2002, one in 2006, and one in 2015. This section summarizes those decisions.

The Court generally found that the conduct in question in each case was insufficient or improper, rather than setting up a norm or prescribing behaviour required to evidence compliance with the "direction and control" mechanism. The following lessons can be learned from these cases regarding the "direction and control" mechanism.

- All of these cases involved charities conducting activities outside of Canada through agents as intermediaries. No other intermediary arrangements were involved or reviewed by the courts. It is therefore not clear how these cases would apply to other intermediary arrangements.
- The Court had found that it is important to have an agency agreement in place and that the terms of the contract be followed. In all these cases, the Court found that either no agency agreement was in place or, where there was one in place, the agreement was not followed or was completely ignored.
- Even if an agency relationship is in place (regardless of whether it is evidenced by an agency agreement), the charity must be able to show that it is in control of the agent and is able to report on the agent's activities.
- Most importantly, the onus is on the charity to provide evidence that it is in control; it is not a mere conduit; and it exercised a sufficient degree of control over the use of its funds by the agent. It must be shown that the agent carries out the activities of the charity, not the activities of the agent or of another organization.

(i) *Canadian Committee for the Tel Aviv Foundation v R*

The Federal Court of Appeal in *Canadian Committee for the Tel Aviv Foundation v R* ("*Tel Aviv*")[62] at the time defined the "direction and control" test to mean that a the charity that uses an agent to conduct its activities must be in control of the agent, be able to report on the agent's activities, and can provide evidence to show that it exercised a sufficient degree of control over the use of its funds.

This case involved an appeal of the Minister's proposal to revoke the charitable registration of The Canadian Committee for the Tel Aviv Foundation (the "Committee"). The Committee's charitable objects are for the promotion of education and relief of poverty and sickness in Tel Aviv, Israel. Its registration was based on its representations to CRA that its activities would be carried out through The Tel Aviv, its agent in Tel Aviv, pursuant to a written agency agreement.

[61] *Ibid,* s 6; CRA Domestic Activities Guidance, *supra* note 44, s 4.

[62] *Canadian Committee for the Tel Aviv Foundation v R*, 2002 FCA 72 [*Tel Aviv*].

The Committee was audited a number of times by CRA. Upon the last CRA audit, CRA proposed to revoke the charitable status of the Committee. The appeal was dismissed by the Court.

The Court acknowledged that a charity may carry on its own activities through an agent. However, in doing so, the charity must be in control of the agent and must be able to report on the agent's activities; and the charity must not act as a mere conduit to funnel funds to the agent. The Court defined the "direction and control" test as follows:

> … It is common ground that a charitable organization is considered to be *carrying on its own activities* to the extent that it acts *through an agent*.[63]
>
> … Under the scheme of the Act, it is open to a charity *to conduct its overseas activities* either using its own personnel *or through an agent*. However, it cannot merely be a conduit to funnel donations overseas. ...[64]
>
> … Pursuant to subsection 149.1(1) of the Act, a charity must devote all its resources to charitable activities *carried on by the organization itself*. While a charity may carry on its charitable activities through an agent, the charity must be prepared to satisfy the Minister that it is at all times *both in control of the agent, and in a position to report on the agent's activities*. …[65]
>
> [emphasis added]

The Court found that the Committee failed to meet the required test because it completely ignored the agency agreement that was in place, and the Committee was not able to provide evidence to show that it had "control over how those funds were spent":

> … The evidence that was provided would suggest that the Committee was merely acting as a conduit for Canadian donors to overseas donees. For example, the evidence discloses that the Committee sent the majority of the funds it raised to its agent in Israel, but provided little documentary evidence of the Committee's control over how those funds were spent. [66]

The Court rejected the Committee's argument that having an agency agreement was not relevant because it was superseded by oral arrangement. The Court found that there was a complete lack of "documentary evidence of direction and control" by the Committee of its agent:

> … The Committee submits that the written Agency Agreement was superceded by subsequent oral arrangements with its agent, and asserts that its directors

[63] *Ibid* at para 7.

[64] *Ibid* at para 30.

[65] *Ibid* at para 40.

[66] *Ibid* at para 30.

> had travelled to Israel on numerous occasions specifically to oversee and direct the agent's activities pursuant to those oral arrangements. Again, however, there is little evidence on the record from which this Court might conclude that the Committee was, in fact, *exercising the control and direction it claims*….[67] [emphasis added]
>
> In my view, in light of this conflict between the Agency Agreement and alleged oral arrangements, and considering the many other concerns raised by the Minister, such as the improper recording of expenditures in the Committee's records, the agent's failure to keep a separate bank account, and the lack of documentary evidence of direction and control by the Committee, it was not unreasonable for the Minister to conclude that the *Committee was not in control or direction of its agent* in Israel.[68] [emphasis added]

The Court dismissed the appeal because the Committee was not able to provide evidence to show that it "exercised a sufficient degree of control over the use of its funds":

> … In this case, the Minister's main reasons for revocation are that the Committee could not demonstrate, through documentary evidence, that it *exercised a sufficient degree of control over the use of its funds* by its agent in Tel Aviv and the Committee did not keep proper books and records of activities carried on by its agent. Even though the Minister's reasons are couched in terms of non-compliance with the Agency Agreement, the requirements under the latter are, in my view, simply a means of ensuring compliance with the Act. …[69] [emphasis added]

(ii) *Canadian Magen David Adom for Israel v Canada (Minister of National Revenue)*

The Federal Court of Appeal in *Canadian Magen David Adom for Israel v Canada (Minister of National Revenue)* [70] ("*Magen David Adom*") involved the revocation of charitable status of Canadian Magen David Adom for Israel ("CMDAI") that provided ambulances and related medical supplies to an organization in Israel.

The Court stated that a charity may operate a program through an agent, provided that the agency relationship is established by a contract, the contract is adhered to, the agent is in fact acting on behalf of the charity, and the charity is in a position to establish that acts of the agents are effectively authorized, controlled and monitored by the charity:

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[67] *Ibid*.

[68] *Ibid* at para 31.

[69] *Ibid* at para 40.

[70] *Canadian Magen David Adom for Israel v. Canada (Minister of National Revenue)*, 2002 FCA 323 [*Magen David Adom*].

> As explained earlier, a charitable organization is obliged to carry on its charitable activities itself. If it does not do so, its registration may be revoked. A charitable organization that wishes to operate in a location where it has no officers or employees must somehow act through a person in that location. *That obviously could be done by establishing an agency relationship between the charity and the* person. Evidence that such a relationship has been established by contract, and that the contract has been adhered to, might well be the most straightforward means of proving to the Minister that a person purporting to carry out the charitable activities of a charity in a particular location *is in fact acting on behalf of the charity.* It is possible that the same result might be achieved by other means. However, a charity that choses to carry out its activities in a foreign country through an agent or otherwise must be *in a position to establish that any acts that purport to be those of the charity are effectively authorized, controlled and monitored by the charity*.[71] [emphasis added]

In dismissing the appeal, the Court rejected CMDAI's argument that although there is no written agreement, there is and always has been an agency relationship with the agent. Instead, the Court found that there was no evidence that there was ever an agency relationship with the agent except CMDAI's "bare assertions to that effect", nor was there any evidence that CMDAI took any steps to control or monitor the use of the ambulances and related equipment provided to the agent.[72]

The Court also rejected CMDAI's argument that the existence of an agency relationship was not essential in this case because CMDAI was able to rely on CRA's "charitable goods policy" contained in an internal CRA staff memorandum dated December 11, 1985 regarding the transfer of goods and services to non-qualified donees. Under the "charitable goods policy", less monitoring would be required by a charity where it made transfers to non-qualified donees involving resources (because of their nature) that can only be used for the charitable purposes of the charity and there is a reasonable expectation that the intermediary to whom the resources have been transferred will use them only for those charitable purposes.[73] In rejecting this argument, the Court held that while it was "prepared to assume, without deciding, that a legal justification could be found for the policy," CRA had no obligation to continue the charitable goods policy that it previously expressed in 1985.[74] Nevertheless, the Court found that the charitable goods policy did not apply to this case because there was no evidence "to support a

[71] *Ibid* at para 66.

[72] *Ibid* at para 75.

[73] *Ibid* at paras 19, 68.

[74] *Ibid* at paras 68, 69.

reasonable expectation that the ambulances and related equipment provided" to the agent by CMDAI were used by the agent only for charitable purposes.[75]

(iii) Bayit Lepletot v Canada (Minister of National Revenue)

The Federal Court of Appeal in *Bayit Lepletot v Minister of National Revenue*[76] ("*Bayit Lepletot*") considered whether Bayit Lepletot ("BL") was carrying on its "own" charitable activities when it funded an orphanage in Israel of the same name through an agent.

In this case, the agent requested funds from BL, which approved the request, transferred the funds to the agent and then the agent disbursed them to the orphanage. The agent was part of the "Directorate in residence" of the orphanage and the agent presumably exercised the same control over the operations of the orphanage, but there was no evidence as to what extent. There was no evidence that the agent exercised any control over the activities of the orphanage in his capacity as agent of BL.

The Court held that when a charity conducts activities through an agent, it must be shown that the agent is actually carrying on the charitable works of the charity and the activities of the agent must be subject to the charity's control:

> It is open for the appellant to carry on its charitable works through an agent but it must be shown that the agent is actually carrying on the charitable works. It is not sufficient to show that the agent is part of another charitable organization which carries on a charitable program. The question which remains in such a case, as it does here, is who is carrying on the charitable works. It was incumbent upon the appellant to show that they were being carried on its behalf. On the record before us it was open to the Minister to conclude that it had failed to do so.
>
> The appellant argues that the Minister is wrong in law to require proof that the activities of the agent are subject to the appellant's control. The Minister's concern with respect to control of the agent's activities is not directed to proof of the agency relationship but rather to the issue of whether the charitable works are the appellant's charitable works or someone else's.[77]

The Court dismissed the appeal because BL was unable to evidence that the agent was actually carrying on the charitable works of BL, instead of the activity of the foreign entity.

[75] *Ibid* at para 74.

[76] *Bayit Lepletot v. Canada (Minister of National Revenue)*, 2006 FCA 128 [*Bayit Lepletot*].

[77] *Ibid* at paras 5, 6.

(iv) *Public Television Assn. of Quebec v Minister of National Revenue*

The Federal Court of Appeal in *Public Television Assn. of Quebec v Minister of National Revenue* ("*PTAQ*") [78] referred to previous case law that charities may conduct charitable activities through agents as intermediaries. However, the Court held that that having an agreement on its own will not necessarily evidence that the charity is exercising direction and control over its resources when an agent is used as an intermediary to conduct charitable activities. In order to demonstrate the required direction and control over its resources, the charity must actually perform its obligations under an agreement and the onus is on the charity to adduce evidence to support it.

The Public Television Association of Quebec ("Association") was a registered charity for the purpose of advancing education through the production, distribution and promotion of non-commercial television programs and films that are educational in nature. It entered into agreements in 1991 with a U.S. charity, Vermont ETV Incorporated ("VPT"), for broadcasting and fundraising. Following an audit in 2007 for fiscal periods ending in 2005 and 2006, CRA found that the Association had failed to devote all of its resources to charitable activities and decided to revoke its charitable status. Following an unsuccessful objection to CRA's Appeals Branch, the Association appealed to the Federal Court of Appeal, which dismissed the appeal.

In making its decision, the Federal Court of Appeal first continued to refer to the ability of charities to conduct charitable activities through an agent. In this regard, the Court referred to the decisions in *Tel Aviv*[79] and *Bayit Lepletot*[80] that a charity can conduct its charitable activities through an agent, provided that the charity is "both in control of the agent and in a position to report on that agent's activities" and that it can demonstrate not only "that the agent is carrying on the work on its behalf but that proof of control over the activities of the agent is necessary to establish that the charitable works are those of the charity and not those of the agent."[81]

Second, the Court held that the onus is on the charity to demonstrate that it has control over the agent's activities and is not acting as a mere conduit in that "[t]he jurisprudence is clear, the *onus* lies on the charitable organization to overturn the Minister's assumption and in order to do so; it must adduce evidence that it is carrying on the charitable works on its own behalf and not merely acting as a conduit. The control over the agent's activities is a key element to establish that it maintained direction and control over its resources."[82]

The Court found the record was insufficient to demonstrate that the Association maintained direction and control over VPT. In particular, the FCA held that the Minister's determination was reasonable because the Association did not: follow or respect the provisions of its agreements with VPT; adduce evidence "that it exercised proper control over the activities of its agent by demonstrating how it monitored the cost of the broadcasting activities, the donations received and the fundraising"; or establish "how the Minister erred in coming to the conclusion that the Association is only used to issue receipts for donations received by VPT from Canadian donors."[83]

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[78] *Public Television Assn. of Quebec v. Minister of National Revenue*, 2015 FCA 170 [*PTAQ*].

[79] *Tel Aviv*, *supra* note 62.

[80] *Bayit Lepletot, supra* note 76.

[81] *PTAQ*, *supra* note 78 at paras 41, 43.

[82] *Ibid* at para 44.

[83] *Ibid* at para 55.

Finally, the case shows that considerable weight will continue to be put on the issue of whether a written agreement is in place between the charity and the third party intermediary. The decision also underscores the fact that the courts will not hesitate to disregard the written agreement if the charity is not able to adduce sufficient evidence to substantiate that the provisions of a written agreement have in fact been followed or respected.

(c) *Difficulties Experienced in the Sector*

It has been pointed out by many in the charitable sector that the direction and control mechanism has many difficulties and challenges. This paper does not intend to discuss in detail the sector's concerns. The following is a summary of some the key difficulties and challenges:[84]

Outdated international development approach

- Requiring charities to have a top-down approach to exercise "direction and control" to dictate the charitable activities and how they are carried out, no matter how small or distant the funding or the program is imperialistic, parochial and offensive. This approach is fundamentally at odds with current international development philosophy that recognizes the importance of developing empowering partnerships with local communities and non-governmental organizations (NGOs).
- This approach is also inconsistent with the Canadian government's policies on working with First Nations and international communities.

Uncertain CRA requirements

- Many of CRA's requirements do not clarify which requirements are mandatory and which ones are optional. Some of the requirements in the Guidances are indicated as a "recommendation" of CRA, which implies that they are optional for charities to undertake. However, not following the recommended steps often result in CRA audits. Other requirements in the Guidances are indicated as what charities "should" do, but it is not clear whether they are "mandatory". These uncertainties often result in charities erring on the side of caution by treating all of them as mandatory requirements and thereby making compliance even more difficult.

Impractical and unrealistic to comply

- The top-down approach to exercise "direction and control" is undesirable, impractical and unrealistic in many respects, reflecting an environment of micro-management that deters and distracts charities from focusing on delivering the programs. Requiring charities to know all the details of a project from start to finish before the project begins in order to

[84] See e.g. Andrew Valentine, "Foreign Activities by Canadian Registered Charities: Challenges and Options for Reform" (21 November 2016) The Philanthropist, online: <https://thephilanthropist.ca/2016/11/foreign-activities-by-canadian-registeredcharities-challenges-and-options-for-reform/>; Malcolm D Burrows, "New Series: Canadian Charities Working Internationally" (22 March 2015) The Philanthropist, online: <https://thephilanthropist.ca/2015/03/new-series-canadian-charities-working-internationally-2/>; John Lorinc, "The Problems with Direction and Control" (6 April 2015) The Philanthropist, online: <https://thephilanthropist.ca/2015/04/international-series-the-problems-with-direction-and-control/>; Juniper Glass, "Do Canada's internationally focused charities operate in an enabling environment?" (20 April 2015) The Philanthropist, online: <https://thephilanthropist.ca/2015/04/do-canadas-internationally-focused-charities-operate-in-an-enabling-environment/>; Evidence presented by various witnesses to the hearing of The Special Senate Committee on The Charitable Sector from February 2018 to April 2019, online: <https://sencanada.ca/en/Committees/cssb/MeetingSchedule/42-1?mode=PAST>; Canadian Council for International Co-operation, "Directed Charities and Controlled Partnerships: A Policy Brief on Charitable 'Direction and Control' Regulation in Canada's International Development and Humanitarian Sector" (15 October 2019), online: <https://ccic.ca/wp-content/uploads/2019/10/Directed-Charities-and-Controlled-Partnerships-Final.pdf>.

give "direction and control" is impractical and unrealistic. This approach also ignores the benefit of relying on the expertise of the local partner doing the work on the ground.

- Charities are required to take "all necessary measures" to exercise direction and control. The monitoring, management and reporting rules are onerous and disproportionate.

- Although CRA "recommends" charities to obtain "original source documents whenever possible," CRA also requires that charities "should be able to explain why it cannot get them, and make all reasonable efforts to get copies and/or reports and records from staff and intermediaries to support its expenditures, and show that it has made such efforts.[85] This means that, in practice, charities have to obtain original source documents and to explain why if they do not have them.

- The rules make it very difficult for charities to work as part of an international network where the Canadian charity in the network is required to put in place separate, complex, and onerous compliance protocols and processes that are not otherwise required by other parties in the network. It is also unrealistic to require the Canadian charity to exercise direction and control where the Canadian charity may provide only a very small part of the funding.

- It is unrealistic and impractical for charities to carve out a portion of international projects collaboratively undertaken by global NGO partners in order that the Canadian charity may meet the requirement to be able to "direct and control" the carved out portion.

- Onerous compliance requirements and severe consequences of non-compliance (including the loss of charitable status) are deterrent factors that discourage charities from engaging in foreign activities all together.

- CRA's set of rules are premised on application to small charities with narrow charitable purposes and activities, but are difficult, if not impossible, to implement for large NGOs or complex projects.

- The rules are unrealistic and impractical for Canadian charities that are branches or parts of an international network or operated under a foreign head body with different branches or parts worldwide working collaboratively. The *de minimis* threshold exemption for head bodies of the lesser of $5,000 or 5% of income is much too low to be of any practical use.

- The rules make it very difficult, if not impossible, for charities to engage in activities involving capacity building or capital property.

High Administrative Costs

- Compliance with the onerous CRA requirements often require high administrative costs, even in situations where the charity otherwise has no concerns with a trusted foreign partner, where efforts undertaken are ineffective and of little or no value to identify non-

[85] CRA Foreign Activities Guidance, *supra* note 44, s 8.1.

compliance issues by the partner. This in turn draws precious and scarce resources away from charitable work and represents a poor expenditure of charitable resources.
- The onerous compliance requirements are also a deterrent that prevents smaller charities from engaging in foreign activities.

Restrictive legal relationships

- The legal relationships referred to in the CRA polices are very restrictive and impractical. They do not reflect the diversity of relationships that charities need to enter into when carrying out programs outside Canada in different contexts.

- The use of an agency relationship is generally not desirable because it will expose the charity to liabilities of the intermediary due to the principal/agent relationship. The vicarious liability that the charity faces as principal for the actions of the agent means that the CRA policies are unnecessarily forcing charities operating outside of Canada to expose themselves to more liability than they need to, which they may not even be aware of.[86] Even if a charity and its board of directors do become aware of the liability that they are taking on having to enter into an agency agreement in order to meet the expectations of CRA, it may be very difficult, if not impossible, for the charity to obtain the insurance that they need to cover the risks associated with the activities of their agents that the charity is responsible for, particularly involving claims arising out of abuse, whether it be sexual, physical or emotional.

- Under agency law, funds paid to an agent cannot be recorded as disbursements on the books of the charity until they have been actually spent by the agent, which may be problematic for a charity attempting to meet its 3.5% disbursement quota at the end of a fiscal year by making disbursements to an agent if the agent is not able to disburse those funds within that same fiscal period.

- As noted above, the use of an agency relationship was first accepted by CRA in the 1980s. Based upon the problems identified above, it is evident that the agency option developed by CRA has not been wholly successful in addressing their concerns. From the court cases reviewed above, it is clear that this mechanism can fail for various reasons, including ignorance of the requirements among charities, inadvertent non-compliance, and even outright fraud or shams. Experience shows sometimes charities are not even aware of the policy; at other times, they seek clarification of it; and in some instances, abusers contrive bogus agency agreements where agents in foreign countries in effect operate as principals in the relationship. In some circumstances, the Canadian charity was perceived to be a mere fundraiser for the foreign “agent.”

- CRA requires funds received by an agent to be physically segregated by the agent in a separate bank account from the agent’s other funds. Although this requirement reflects the common law principle that funds of the principal are not funds of the agent and should therefore be segregated, there is no legal basis to support CRA’s practice (even though not clearly expressed in the Guidances) that funds be segregated in a separate bank account by all types of intermediaries, not just agents.

[86] For further details on vicarious liability of principals and agents, seethe Supreme Court of Canada cases of *London Drugs Ltd. v Kuehne & Nagel International Ltd*., [1992] 3 SCR 299 and *Bazley v Curry*, [1999] 2 SCR 534.

- Although CRA accepts the use of contract for services to engage intermediaries, this mechanism is ill suited as explained below regarding problems faced by the charitable sector when they utilize a contract for services for charitable activities, as opposed to a grant, in the U.S. and U.K. regime. A contract for services involves a mutual bargain with consideration paid and the transfer is a purchaser of a service at an agreed standard and price. This mechanism does not always align with how charities want to conduct activities to further their charitable purposes. As well, engaging charities in the U.K. by a contract for services may require the contract be subject to value-added tax. [87]

- If a joint venture arrangement is used, it is not practical for CRA to require a governance structure be in place (such as a joint venture committee and the charity having members sit on the governance structure) where the charity must have decision-making power on the governance structure proportionate to the level of funding it provides.

Inconsistent with other jurisdictions

- The direction and control mechanism requiring the programs to be the "own activities" of the funding Canadian charity is an outlier in the world and not easily understood. It is inconsistent with successful mechanisms utilized by other countries, such as the U.S. and England and Wales. It in essence creates what is perceived to be nothing more than a legal fiction in order to satisfy the requirements of the ITA as interpreted by CRA.

Conflated use for terrorist financing purposes

- It would be inappropriate to continue the use of the direction and control mechanism (a policy of CRA under the ITA) because it is also used as a tool to control and monitor terrorist financing under Canada's onerous anti-terrorism regime. These are two separate regulatory regimes whose enforcement provisions need to be evaluated separately and not be allowed to be conflated in order to create a perception of a reciprocal justification for its continued use.

- Charities that facilitate terrorist activities or supported terrorist groups under Canada's anti-terrorism legislation can lead to a charity becoming susceptible to criminal charges and/or de-registration. Canadian anti-terrorism legislation is a group of federal statutes that include the *Anti-Terrorism Act*,[88] the anti-terrorism provisions of the *Criminal Code*,[89] the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act*,[90] and other legislation in pursuit of the government's anti-terrorism objective. In this regard, charitable status of a charity may be revoked and application for charitable status may be rejected if the organization in question has made, makes or will make available any resources, directly or indirectly, to a terrorist entity or an entity engaging in terrorist activities, and thereby could be criminally liable under the *Criminal Code* for allowing their resources be used to commit, finance or facilitate terror attacks.

[87] For further information on grants and contracts, see section 5, below.

[88] S SC 2001, c 41. See in particular Part VI, which enacted the *Charities Registration (Security Information) Act*, SC 2001, c 41, s 113.

[89] RSC, 1985, c C-46 [*Criminal Code*]. See e.g. ss 83.02-83.04, 83.08, 83.14, 83.18 and 83.22.

[90] SC 2000, c 17.

- In this regard, it has been pointed out that the enforcement of anti-terrorism legislation has involved imposing "a legal framework to the regulatory provisions of direction and control to groups and individuals listed under national or international terrorism sanctions regimes."[91] Specifically, CRA indicated that where terrorist financing may be a concern, they may not enforce anti-terrorism legislation, but rather use enforcement tools under the ITA including the "own activities" test and direction and control. In this regard, CRA provided evidence to the Standing Senate Committee on National Security concerning CRA's involvement in preventing charities becoming involved in terrorist activities or terrorist financing that:

> Mr. Alastair Bland: Where there are concerns regarding the risk of terrorist abuse, there are likely also issues with an organization's ability to meet the requirements of the *Income Tax Act*. As a result, in or interactions with organizations, we do not always indicate to them that we have concerns related to terrorism.
>
> The complexity of our files requires that we adopt a nuanced approach. For instance, in the course of an audit, we may come across information that suggests that a registered charity is providing funds to a foreign organization that has been identified as having links to a terrorist entity. Our concern would be that the funds raised by the Canadian organizations in Canada are at risk of being diverted by the foreign organization to support their terrorist activity.
>
> Our focus would therefore be on the *Income Tax Act* requirement that organizations must carry out their own charitable activity. Funding non-qualified donees – that is, providing funds to an unqualified recipient – constitutes a breach of the *Income Tax Act* could form the basis for revoking an organization's registered status. [Emphasis added]
>
> […]
>
> We audit organizations where there are indicators or a risk that terrorist financing could occur from their activities. We then apply the measures, as I indicated in my opening remarks, of the provisions under the *Income Tax Act* to disrupt that possibility.
>
> […]
>
> Ms. Cathy Hawara: Under the *Income Tax Act*, all charities have to direct and control their assets. They have to carry out their own charitable activities. They can't simply gift their money or their resources to whomever they wish.

[91] Canadian Council for International Co-operation, *supra* note 84.

> By virtue of applying those rules, we can address the risks that we know are there.[92] [Emphasis added]

While it is an important policy goal under the anti-terrorism legislation to prevent charities from being used as a tool for terrorist activities or financing, this goal should be achieved through specific enforcement provisions in the anti-terrorism legislation, rather than "piggy backing" onto the enforcement tools for ITA purposes of the "own activities" test. Whether a charity is able to adduce, to the satisfaction of CRA, that there is sufficient evidence of direction and control in place when working through an intermediary to meet the "own activity test" under the ITA has no correlation whatsoever to whether or not a charity may be "directly or indirectly facilitating" a terrorist activity or terrorist group under the *Criminal Code*.[93] In fact, maintaining a direction and control mechanism is not a requirement in the anti-terrorism legislation.

- Accordingly, there is a perception that any alternative solution to solve the "direction and control" problem might become an impediment to the government's efforts to prevent terrorist activities and financiering by taking away the enforcement tool of direction and control. These are two separate compliance objectives existing under two different legislative regimes, though the fact that the anti-terrorism regime requires monitoring and enforcement tools to deal with a few remote situations should not mean that all charities should be inappropriately burdened under the tax regime with the current "own activities" test regime with its corresponding requirement for direction and control.

4. Other Jurisdictions

This section of the paper reviews the regulatory regime in the U.S. and England and Wales for grant making to foreign entities.

(a) *U.S.*

Rules in the U.S. that govern U.S. charities with respect to making grants to foreign organizations differ depending on the type of U.S. charities in question under the *Internal Revenue Code* § 501(c)(3) ("Code").

In the U.S., charitable organizations are divided into two groups, public charities and private foundations, under the *Internal Revenue Code* § 501(c)(3) provided that they are organized and operated exclusively for exempt purposes. Treasury regulations provide that an organization will be regarded as operated exclusively for exempt purposes if it engages primarily in activities that further exempt purposes.[94] All charitable organizations are deemed to be private foundations (which are subject to more stringent regulations) unless they qualify as public charities. Generally, public charities (a) have broad public support, (b) actively function to support public charities, or (c) are devoted exclusively to testing for public safety. Many public charities rely on contributions from the general public. Private foundations, however, are charitable organizations that do not

[92] Cathy Hawara & Alastair Bland, "Proceedings of the Standing Senate Committee on National Security and Defence" (11 April 2016), online: Government of Canada <https://sencanada.ca/en/Content/Sen/Committee/421/SECD/03ev-52467-e>.

[93] *Criminal Code*, *supra* note 89, ss 83.02-83.04, 83.18, 83.21-83.22.

[94] Code § 501(c)(3); Treas Reg § 1.501(c)(3)-1(d)(1)(i).

qualify as public charities. Generally, a private foundation is funded from one source, its ongoing funding is usually in the form of investment income (rather than from a flow of investment income), and it makes grants for charitable purposes to other persons (rather than conducting its own programs).[95]

(i) Public Charities

Public charities in the U.S. may make grants to foreign charities to be used solely for charitable purposes. Requirements on grant making by public charities are not set out in the Code or Treasury regulations. Instead, they are set out in revenue rulings that have evolved over time, which are official Internal Revenue Service interpretations of the requirements in the Code and regulations.

In general, when a public charity makes a grant, it must retain control and discretion as to the use of the funds, maintain records to establish that the funds are used for section 501(c)(3) purposes, and limit distributions to specific projects that further the charity's own purposes. This "control and discretion" requirement applies regardless of whether the funds are used for domestic or foreign activities. Generally, this would involve the charity taking reasonable steps of due diligence, including conducting pre-grant vetting, entering into a written grant agreement, as well as conducting field investigations where possible.[96]

The charity would also be required to maintain adequate records and case histories, to include the following: "1. the name and address of the recipients; 2. the amount distributed to each; 3. the purpose for which the aid was given; 4. the manner in which the recipient was selected; and 5. the relationship, if any, between the recipient and (i) members, officers, or trustees of the organization; (ii) a grantor or substantial contributor to the organization or a member of the family of either; and (iii) a corporation controlled by a grantor or substantial contributor."[97] Most of the information in this list may also be required to be reported in the charity's annual report to the Internal Revenue Service in Form 990 Schedule F.

It has also been suggested that although public charities are not required to make a determination that the foreign grantee is the equivalent of a section 501(c)(3) organization (as in the case of the equivalency determination test for private foundations explained below), they would be in a stronger position on audit if it has done so and supported by appropriate documentation.[98] It was also suggested that this is a recommended approach because it could help simplify administrative mid recordkeeping burdens.[99]

From a practical standpoint, it has also been suggested that public charities should obtain copies of all of the grantee's organizational documents, a description of its activities and programs, as well as proposed activities. As well, the written grant agreement should require the grantee to

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[95] Bruce R Hopkins, *The Law of Tax-Exempt Organizations*, 9th ed (Hoboken, NJ: John Wiley & Sons, Inc, 2007) at 352-353.

[96] IRS, Revenue Ruling 71-460 1971-2C.B. 231; Revenue Ruling 68-489, 1968-2 C.B. 210; 306; Revenue Ruling 75-65, 1975-1 C.B. 79.

[97] IRS, Revenue Ruling 56-304, 1956-2 C.B.

[98] Jane Peebles, "Cross Border Gifts" (1999) *Planned Giving Design Center Network,* online: <https://www.pgdc.com/pgdc/cross-border-gifts>.

[99] Patrick Boyle et al, "Comparing The Ability Of Canadian And American Charities To Operate And Fund Abroad – Tips On Foreign Activities By Canadian Charities" (May 2006), paper presented at Charity Law Symposium of the Canadian Bar Association and Ontario Bar Association, online: <http://www.cba.org/cba/cle/pdf/charity_tab3b.pdf>.

use the funds for strictly charitable purposes, and specific purposes for the grant funds with sufficient details because "it is unsafe to make a grant for the general support of a foreign charity unless the grantee is clearly the equivalent of a section 501(c)(3) organization operated exclusively for charitable purposes, since such a grant would shift discretion over the use of the funds from the U.S. grantor to the foreign grantee."[100] Similarly, it is recommended that the written grant agreement also require the grantee to comply with the basic requirements of section 501(c)(3), such as prohibition from private inurement, influence legislation or affect the outcome of elections, or distribute assets in the event of termination.[101] Similarly, reporting requirements should include a written financial report at the end of each of accounting period, including a description of how the funds are used, how the grant terms are complied with, and the progress made in achieving the purpose of the grant.[102] Furthermore, as part of the due diligence, the public charity should also ensure that the grant will not be used to support or be used in terrorist acts or by terrorist organizations.[103]

Although the grantmaking requirements for public charities is perceived by some to be less onerous than those for private foundations (explained below), it has also been pointed out that the substances of the requirements in the "control and discretion" standard for public charities and the "expenditure responsibility" rules for private foundations are "very similar and uses similar terminology, with the exception of some of the specific terms of grant agreements and the annual Form 990-PF expenditure responsibility grant reporting requirement" with the "key difference that thus emerges between the requirements for publicly-supported charities and private foundations is the form in which the standards are set forth, and the timing and nature of the sanctions imposed for failing to meet the requirements." Accordingly, a good faith effort to comply with the revenue rulings for public charities will likely generate the appropriate documentation similar to those required under the "expenditure responsibility" rules.[104]

(ii) Private Foundations

Although U.S. public charities may make grants, grantmaking in the U.S. is usually made by private foundations, which are required to comply with stringent requirements in the Code, of which failure to comply would subject them to excise tax under section 4945 of the Code. In this regard, section 4945(a) of the Code imposes an excise tax on private foundations if they make a "taxable expenditure." A taxable expenditure includes a grant to an organization unless (i) the grant is made to a public charity or private operating foundation or (ii) the foundation exercises expenditure responsibility with respect to such grants in accordance with section 4945(h).[105] Instead of complying with the expenditure responsibility requirements, the private foundation

[100] Peebles, *supra* note 98.

[101] *Ibid*.

[102] *Ibid*.

[103] U.S. charities making overseas grants should be familiar with the *Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT ACT) Act of 2001*, and in particular the Treasury requirements under s 311, as well as of United States Code, 18 USC § 2339B, which makes it a federal crime, punishable by up to 15 years in prison, to "knowingly provid[e] material support or resources to a foreign terrorist organization."

[104] Marcus S Owens, "Legal Framework of International Philanthropy: The Potential for Change" (2005) 25 Pace L Rev 193, online: <https://digitalcommons.pace.edu/plr/vol25/iss2/1>.

[105] 26 US Code § 4945(d)(4).

may make a good faith determination and reasonable judgment that the foreign grantee is equivalent to U.S. public charities.

Not every disbursement made by a private foundation to another is a "grant". The term "grant" is defined differently in different parts of the Code. For purposes of section 4945(d)(4), grants (under Treasury Regulation 53.4945-4(a)(2) [106]) involve a list of what payments are and are not accepted as grants, which include at least the following: amounts spent by the recipient organization to carry out a charitable activity; amounts used by the recipient for scholarships, fellowships, internships, prizes, and awards; loans used by the recipient for any of the above; and program-related investments in the form of loans or equity. However, grants do not include amounts paid to an organization to provide services for the grantor.[107]

Expenditure Responsibility

"Expenditure responsibility" means that the private foundation is responsible to exert all reasonable efforts and to establish the following procedures.[108]

(1) Limited pre-grant inquiry – The grantor foundation must conduct a limited pre-grant inquiry concerning the potential grantee which is complete enough to give a reasonable person assurance that the grantee will use the grant for the proper purposes. The inquiry should concern itself with matters such as: the identity, prior history, and experience (if any) of the grantee organization and its managers; and any knowledge which the private foundation has of, or other information which is readily available concerning, the management, activities, and practices of the grantee organization. The scope of the inquiry may vary from case to case depending on the size and purpose of the grant, the period over which it is to be paid, and the prior experience which the grantor has had with respect to the capacity of the grantee to use the grant for the proper purposes.[109]

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[106] The definition of grants in Treas Reg § 53.4945-4(a)(2) applies to both grants to individuals in Treas Reg § 53.4945-4 and grants to organizations in Treas Reg § 53.4945-4 as follows:

> (2) "Grants" defined. For purposes of section 4945, the term "grants" shall include, but is not limited to, such expenditures as scholarships, fellowships, internships, prizes, and awards. Grants shall also include loans for purposes described in section 170(c) (2) (B) and "program related investments" (such as investments in small businesses in central cities or in businesses which assist in neighborhood renovation). Similarly, "grants" include such expenditures as payments to exempt organizations to be used in furtherance of such recipient organizations' exempt purposes whether or not such payments are solicited by such recipient organizations. Conversely, "grants" do not ordinarily include salaries or other compensation to employees. For example, "grants" do not ordinarily include educational payments to employees which are includible in the employees' incomes pursuant to section 61. In addition, "grants" do not ordinarily include payments (including salaries, consultants' fees and reimbursement for travel expenses such as transportation, board, and lodging) to persons (regardless of whether such persons are individuals) for personal services in assisting a foundation in planning, evaluating or developing projects or areas of program activity by consulting, advising, or participating in conferences organized by the foundation.

[107] 26 CFR § 53.4945-4(a)(2), available online: *Legal Information Institute* <www.law.cornell.edu/cfr/text/26/53.4945-4>.

[108] IRS, *IRC Section 4945(h) – Expenditure Responsibility* (last reviewed or updated 5 November 2018), online: <www.irs.gov/charities-non-profits/irc-section-4945h-expenditure-responsibility>. See also Marcus S Owens, "International Grantmaking by U.S. Foundations: The Concept of Expenditure Responsibility" (14 April 2015) The Philanthropist, online: <http://thephilanthropist.ca/2015/04/3865/>; IRS, *International Grants and Activities* (memorandum document no. 200504031) (26 January 2004), online (pdf): <www.irs.gov/pub/irs-wd/0504031.pdf>; Robert A Wexler, "Expenditure Responsibility – A Primer and Ten Puzzling Problems" (September 2010), online: *Adler & Colvin* <www.adlercolvin.com/expenditure-responsibility-a-primer-and-ten-puzzling-problems>.

[109] IRS, *Pre-Grant Inquiry* (last reviewed or updated 26 March 2018), online: <www.irs.gov/charities-non-profits/private-foundations/pre-grant-inquiry>.

(2) Written terms of the grant – The grantor foundation must obtain written commitment signed by an appropriate officer, director or trustee of the grantee organization. This is generally in the form of an agreement. The written commitment must include agreement by the grantee: to use the grant for the purposes stated in the agreement; to repay any portion of the grant fund not used for the purposes of the grant; to submit full and complete annual reports on the manner in which the funds are spent and the progress made; to maintain records of receipts and expenditures and to make its books and records available to the grantor at reasonable times; and not to use any of the funds for activities prohibited by the Code. With regard to the annual reports, the regulations specify that the grantor foundation need not conduct any independent verification of the reports unless it has reason to doubt the accuracy or reliability of them.[110]

(3) Reports from the grantee – The grantor foundation must obtain reports from the grantee on: the use of the funds; compliance with the terms of the grant; and progress made by the grantee. Generally, the grantee must make such reports at the end of its annual accounting period within which the grant is received.[111]

(4) Reports to the IRS – The grantor foundation must make full and detailed reports regarding the grants to the Internal Revenue Service on its annual reporting Form 990-PF. The report must contain the following details concerning each grant: name and address of grantee; date and amount of the grant; purpose of the grant; amounts expended by the grantee; whether the grantee has diverted any portion of the funds from the purpose of the grant (to the knowledge of the grantor); dates of any reports received from the grantee; date and results of any verification of the grantee's reports undertaken pursuant to and to the extent required under the Code by the grantor or by others at the direction of the grantor.[112]

(5) Record keeping – In addition to keeping records containing information for reporting to the IRS in Form 990-PF, the grantor foundation must maintain and make available to the IRS copies of the following: agreements covering each "expenditure responsibility" grant made during the taxable year; reports received during the taxable year from each grantee on any "expenditure responsibility" grant; and reports made by the grantor's personnel or independent auditors of any audits or other investigations made during the taxable year with respect to any "expenditure responsibility" grant.

Failure to comply with any one of the expenditure responsibility requirements will cause the grant to be a taxable expenditure and subject to tax imposed by section 4945(a)(1) of the Code. As well, grant funds diverted for improper purposes can meet expenditure responsibility requirements if reasonable and appropriate steps were taken by the grantor foundation to recover lost funds and future payments were suspended. In this regard, penalties are in the form of a series of escalating excise taxes, the severity depending on the nature of the offense.

According to the IRS, the expenditure responsibility rules for grantmaking, with their enumerated steps, coupled with the excise tax consequences of a failure to comply, have served as an

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[110] IRS, *Terms of Grants – Private Foundation Expenditure Responsibility* (last reviewed or updated 26 March 2018), online: <www.irs.gov/charities-non-profits/private-foundations/terms-of-grants-private-foundation-expenditure-responsibility>.

[111] IRS, *Reports from Grantees* (last reviewed or updated 26 March 2018), online: <www.irs.gov/charities-non-profits/private-foundations/reports-from-grantees>.

[112] IRS, *Reports to the Internal Revenue Service – Expenditure Responsibility* (last reviewed or updated 26 March 2018), online: <www.irs.gov/charities-non-profits/private-foundations/reports-to-the-internal-revenue-service-expenditure-responsibility>.

effective mechanism for ensuring that international grantmaking accomplishes appropriate charitable goals.[113]

Equivalency Determination

Instead of complying with the expenditure responsibility requirements when a private foundation makes a grant to a foreign entity, the private foundation may make a "good faith determination" that the foreign grantee is equivalent to a section 501(c)(3) U.S. public charity.

One way to make a determination is if the potential grantee has an IRS determination letter that it is a public charity. If there is no such letter, the private foundation can make a good faith determination and reasonable judgment that the potential grantee is equivalent to a section 501(c)(3) U.S. public charity. The determination is usually based on written advice of a qualified tax practitioner, based on information gathered in an affidavit of the potential grantee. The information required in the affidavit is rather extensive and supported by governance and financial documents of the potential grantee. It is intended to allow the IRS to determine whether the potential grantee would qualify for public charity status if it was to apply.[114] If the potential grantee cannot provide the information necessary for the equivalency determination, then the private foundation must exercise expenditure responsibility if it wishes to proceed with making a grant.

(b) *England and Wales*

In England and Wales, charities are expressly permitted to make grants to foreign entities (*i.e.*, entities that are not registered as charities with the Charity Commission for England and Wales) to further the charitable purposes of the grantor charity. The Charity Commission issued a guidance, *Grant funding an organisation that isn't a charity* ("Grant Funding Guidance") that explains "what trustees need to do before deciding whether to make a grant to an organization that isn't a charity."[115] Charities in England and Wales that want to work with other charities (such as fundraising or collaborating to deliver a project or contract) are addressed in a separate guidance, *Work with other charities*.[116]

Unlike the highly prescriptive expenditure responsibility rules in the U.S., the Grant Funding Guidance explains the concerns and principles that charities have to consider and follow and allow charities to develop what would be required depending on their own circumstances, without being prescriptive. The tone of the Grant Funding Guidance is positive, informative, and educational.

In the U.K. regime, transfers by charities to another organization for an activity to further charitable purposes of the grantor charity are not referred to as "gifts". The term "grants" is used.

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[113] Owens, *supra* note 108.

[114] IRS, Revenue Procedure 2017-53, effective September 14, 2017. See also Stephanie L Petit, "IRS Releases Revenue Procedure 2017-53 Foreign Public Charity Equivalency Determinations" (15 Sep 2017), online: <https://www.adlercolvin.com/blog/2017/09/15/irs-releases-revenue-procedure-2017-53-on-foreign-public-charity-equivalence-determinations/>.

[115] Charity Commission of England and Wales, *Grant funding an organisation that isn't a charity* (Guidance) (17 Feb 2016; updated 11 Aug 2017), online: <www.gov.uk/guidance/draft-guidance-grant-funding-an-organisation-that-isnt-a-charity>.

[115] Charity Commission of England and Wales, *Work with other charities* (Guidance) (23 May 2013), online: <www.gov.uk/guidance/work-with-other-charities>.

However, this term is not defined in the *Charities Act 2011* in the U.K. regime. What grant making involves is explained in various guidances of the Charity Commission.

Creating Opportunities and Need for Restrictions

At the outset, the Grant Funding Guidance explains the rationale and reasons for the need to conduct due diligence from a positive empowering perspective that grant making "may present new opportunities" to further the grantor charity's purposes "by reaching individuals or communities that they might not otherwise be able to reach" or "benefit causes or groups which may otherwise struggle to obtain the support they need."

In this regard, grants can be made to different types of entities, including other charities with similar or overlapping purposes; non-charities, including social enterprises, campaigning organizations, commercial companies or public sector bodies; and overseas organizations. Grants can be made for specific activities or services or, in some cases, to develop the organization's capacity to deliver activities or outcomes that will further the charity's own purposes.

It explains that grantor charities need to understand the relevant risks and boundaries for grant making, as well as any opportunities that a grant may provide, before making a grant because grantees are not charities and do not have to deliver public benefit or comply with charitable purposes, and may not be familiar with charity law requirements. It explains that there "will always be limits and conditions on" what grants may be made because grant funds can only be used to further or support the grantor charity's purposes.

Key Steps and Considerations

The Grant Funding Guidance explains that the grantor charity needs to conduct a number of pre-grant due diligence.

First, before a charity decides to engage in grant making, it needs to engage in the following assessment: having a clear understating of the charity's own charitable purposes; following trustee decision-making principles; and putting in place appropriate systems and procedures for making decisions about grants. To assist charity trustees to make decisions in this regard, they are directed to Guidance CC27 *It's your decision: charity trustees and decision making.*[117]

Second, before the charity decides to make a grant to a particular grantee, it needs to engage in the following pre-grant assessment on the grantee: whether the desired grantee organization is a charity, taking reasonable steps to assess risks; as well as carrying out appropriate checks on the grantee organization. In addition, the Grant Funding Guidance indicates that the trustees of the grantor charity need to be aware that they would remain responsible for grant decisions; and understanding where extra care may be needed.

Additional considerations in the grant making process also require: (i) writing appropriate terms and conditions to ensure that the grant can only be used in line with the grantor charity's purposes, and ensure that the grantee understands and accepts them; (ii) putting in place appropriate monitoring arrangements; and (iii) knowing what to do if things go wrong.

These requirements are further explained in the Grant Funding Guidance.

[117] Charity Commission of England and Wales, *It's your decision: charity trustees and decision making* (CC27) (Guidance) (10 May 2013), online: <https://www.gov.uk/government/publications/its-your-decision-charity-trustees-and-decision-making/its-your-decision-charity-trustees-and-decision-making>.

Duties of Trustees in Granting Process

The Grant Funding Guidance explains that since grant funds may only be used to further the grantor charity's charitable purpose, it provides key reminders on duties of charity's trustees in this regard: ensure that everything the charity does helps (or is intended to help) to achieves the charitable purposes of the charity; ensure that the charity is carrying out its purposes for the public benefit; act in the charity's best interests and act with reasonable care and skill; ensure grants are made only for activities or outcomes that achieve the charity's purposes; ensure the charity's governing document do not prohibit making grants to non-charities; and ensure the grantee understands and agrees what the grant can and cannot be used for. To assist trustees understand their duties, they are directed to Guidance CC3 *The essential trustee: what you need to know, what you need to do.*[118]

Appropriate Systems and Procedures

The Grant Funding Guidance states that charities that make grants need to put in place appropriate and proportionate systems and procedures for the following objectives: (i) allow trustees to set priorities for funding; (ii) require sufficient detail in the grant application, and monitoring procedures, to enable the trustees to identify and assess risks and make informed decisions; (iii) enable the charity to carry out appropriate due diligence on organizations applying for grants; and (iv) ensure grants are authorized by the trustees, or within a framework of delegation that ensures appropriate oversight and scrutiny.

Risk Assessment

The Grant Funding Guidance states that appropriate risk assessment is required before a grant is made in order to avoid exposing the charity to undue risk. Risk will need to be identified and considered proportionately in relation to a particular grant proposal because risks vary in significance from case to case. Areas of risk to be considered include operational (delivery), reputational, governance, and financial risks, including exposure to financial crime or tax liability. Charities are directed to helpful tools in a separate guidance, *How to manage risks in your charity* on how to conduct risk assessments.[119]

Due Diligence and Assurance

Charities are also required to carry out appropriate due diligence checks in order to provide assurance that the grantee organization is genuine, reliable and competent to carry out the activity being funded; and that it is suitable for the charity to work with and fund. Due diligence is also required to confirm that the charity's funds have been properly used in line with its purposes; the exposure to risks (such as fraud, financial crime, extremism or terrorism) have been identified and managed; and that awarding the grant is in the best interests of the charity.

What level of due diligence or assurance is appropriate would depend on the level of risk that is involved on the charity's assets, beneficiaries or reputation. The Grant Funding Guidance provides a list of possible due diligence checks on the grantee organization, including the organization's aims (as compared to the purposes of the charity); track record for delivering the activities to be

[118] Charity Commission of England and Wales, *The essential trustee: what you need to know, what you need to do* (CC3) (Guidance) (3 May 2018), online: <https://www.gov.uk/government/publications/the-essential-trustee-what-you-need-to-know-cc3/the-essential-trustee-what-you-need-to-know-what-you-need-to-do>.

[119] Charity Commission of England and Wales, *How to manage risks in your charity* (23 May 2013), online: <https://www.gov.uk/guidance/how-to-manage-risks-in-your-charity>.

funded; governance and constitutional form; reputation; as well as its operations (whether any aspects of its conflicts with the charity's purposes, activities, funding, or other interests. Even if the grantor charity knows the grantee organization quite well, the charity would still need to evaluate the need for due diligence checks, and how extensive those checks would need to be. The Grant Funding Guidance also points out that additional checks may be necessary during the course of the funding relationship if there are risks that are significant or have materially increased. The due diligence process is further explained in detail in a separate guidance, *Charities: due diligence, monitoring and verifying the end use of charitable funds.*[120]

Deciding to Award a Grant

The Grant Funding Guidance provides additional criteria when the grantor charity trustees are ready to decide to award a grant after having conducted the appropriate risk assessment and due diligence. Trustees are to follow and apply the principles in Guidance CC27 *It's your decision: charity trustees and decision making.*[121] Trustees are required to supervise delegated authority through appropriate policies and reporting procedures. Trusts are required to set guidelines to help assess what is likely to be high risk or unusual, where high risk and unusual decisions should not normally be delegated. Since trustees are responsible for deciding what level of scrutiny and discussion are appropriate in the circumstances, they may be asked by the Charity Commission to explain and justify a decision.

Limits on Funding Organizations that Are Not Charities

The Grant Funding Guidance provides that a grant can be made to fund the support costs of activities, services, or outcomes delivered by grantee organizations that are not charities, provided these are intended only to further the grantor charity's own charitable purposes.

When making a decision to grant fund an organization that is not a charity, the charity must ensure that: (i) the grant is only for activities, services or outcomes that will further the charity's purposes for the public benefit; (ii) any funding of support costs is limited to the specified activities, services or outcomes; (iii) the terms of the grant require the recipient to comply with these restrictions; (iv) the grant does not give rise to more than incidental personal benefit; and (v) the grant in the charity's best interests. The same requirements apply where the charity provides a grant to develop a grantee's capacity, provided that the grant funds are only used to develop capacity to deliver activities, services or outcomes that fall within the charity's purposes for the public benefit, and that any personal benefit is incidental.

Setting the Terms of the Grant

The granting relationship would require the charity to write appropriate terms and conditions, and ensure that the grantee organization understands and accepts them. The Grant Funding Guidance lists examples of issues that should be addressed in the terms and conditions, such as reporting requirements and frequency, records to support the reports, appropriate level of monitoring arrangements, and consequences in the event if the terms and conditions are breached, and appropriate protection of the charity's intellectual property rights and reputation.

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[120] Charity Commission of England and Wales, *Charities: due diligence, monitoring and verifying the end use of charitable funds* (Guidance) (3 January 2011), online: <www.gov.uk/government/publications/charities-due-diligence-checks-and-monitoring-end-use-of-funds>.

[121] Charity Commission of England and Wales, *It's your decision: charity trustees and decision making* (CC27), *supra* note 117.

The guidance clarifies that the terms and conditions may be a letter or short agreement if the grant size is small involve low risks, or a more detailed agreement in other situations.

Monitoring

The grantor charity must also put in place appropriate and proportionate monitoring arrangements depending on the value of the grant and the charity's assessment of the risks. There must an appropriate level of monitoring for every grant, even if it seems obvious that it will further the charity's purposes. The monitoring process is further explained in detail in a helpful separate guidance, Chapter 2 of the Charity Commission's *Compliance toolkit*.[122] This guidance provides resources to make trustees aware of their legal duties and responsibilities in carrying out appropriate due diligence checks on those individuals and organizations that give money to, receive money from or work closely with their charity; explains how to identify and manage any associated risks; and gives trustees practical advice on carrying out proper monitoring and verification of the end use of funds where charities give money to local partners and beneficiaries.

Situations Where Extra Care and Scrutiny are Needed

The Grant Funding Guidance provides consideration factors for situations where extra care and scrutiny may be required, with additional explanation in a separate guidance, *Charities: how to manage risks when working internationally*, in relation to issues, such as unstable countries, local employment rules, protection of the charity's staff and beneficiaries, terrorism, tracking money and resources, guarding against fraud and financial crime, and money transfer risks.[123]

If a grant was determined to be a non-charitable expenditure, it might affect the charity's exemption from tax. This expenditure may include an expenditure which was not incurred for charitable purposes only, and payment to an overseas body where the charity has not taken reasonable steps to ensure the payment will be applied for charitable purposes.[124]

The Grant Funding Guidance warns that if grants do not work out as planned, a charity would need to take appropriate action to minimize any financial loss or harm to the charity's beneficiaries or assets, including its reputation. This may include suspending or withdrawing funding or requiring repayment under the terms and conditions of the grant. If a serious incident takes place, the charity is required to report to the Commission what happened and explain how the charity is dealing with it. A serious incident is an adverse event, whether actual or alleged, which results in or risks significant loss of the charity's money or assets, damage to the charity's property, or harm to the charity's work, beneficiaries or reputation.

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[122] Charity Commission of England and Wales, Chapter 2 of the Charity Commission's *Compliance toolkit*: due diligence, monitoring and verifying the end use of charitable funds (3 January 2011), online: <https://www.gov.uk/government/publications/charities-due-diligence-checks-and-monitoring-end-use-of-funds>.

[123] Charity Commission of England and Wales, *Charities: how to manage risks when working internationally*" (Guidance) (10 May 2013), online: <https://www.gov.uk/guidance/charities-how-to-manage-risks-when-working-internationally>.

[124] HM Revenue & Customs, *Guidance Annex ii: non-charitable expenditure* (17 April 2019), online: <www.gov.uk/government/publications/charities-detailed-guidance-notes/annex-ii-non-charitable-expenditure> .

5. Alternative Mechanisms

(a) *Desirable Features for Alternative Mechanism for Canada*

In light of the above review on the ITA "own activity" test, CRA's direction and control mechanism, and how charities in the U.S. and England and Wales may engage in foreign activities, the following are reasons or observations with respect to why it would be desirable to seek a suitable alternative mechanism for Canada in order to help alleviate concerns and difficulties faced by the charitable sector when operating outside Canada:

- Remove own activities test from the ITA – There is no policy, rationale or justification for the continuation of the "own activity" test in the ITA that requires charitable organizations to devote all of their resources to charitable activities carried on by themselves. A charity's "own activities", which includes the use of an agent, is a concept of limited and impractical value. The 2018 amendment to the ITA requiring both charitable organizations and charitable foundations be constituted and operated exclusively for charitable purposes renders the "own activity" test unnecessary. Requiring funded activities to be activities of the Canadian charity conducted through a third party is a restrictive, unrealistic, artificial, and fictitious contortion.

- Furtherance of purpose, not activities – The focus should be on whether a charity uses, in a responsible manner, its resources to further its charitable purposes, not whether it carries on charitable "activities",[125] whether it be its own or otherwise.

- Remove "direction and control" mechanism – CRA's "direction and control" mechanism has many drawbacks, including for example that it: reflects an outdated international development approach; lacks certainty with regard to compliance requirements; is impractical and unrealistic to comply with; requires high administrative costs; restricts the legal relationships for charities conducting foreign activities; and is inconsistent with the regulatory regime in other jurisdictions.

- Since the "direction and control" mechanism is not an ITA requirement, there is flexibility for CRA to replace this mechanism with other mechanisms in its administrative policies that address the concerns by the sector. As well, CRA's direction and control mechanism does not accord with a correct interpretation of the decision in *Tel Aviv*.[126] As reviewed above, the Court in *Tel Aviv* defined direction and control to mean that a charity must be able to account for where and how its funds are spent by its intermediary through the presentation of evidence of direction and control that will allow CRA to determine whether activities are the charities "own activities." As such, the Guidances inappropriately require all charities to comply with an increased and uniform level of direction and control regardless of context has made the interpretation of the Guidances susceptible to uncertainty and arbitrariness.

- Focus on expenditure responsibility – The focus of the new mechanism should be on expenditure control or a establishing an expenditure responsibility grant system, not operational control.

[125] Juneau, *supra* note 18.

[126] *Tel Aviv*, *supra* note 62.

- Practical, clear and flexible – The new mechanism must be practical and realistic to comply with, and be sufficiently flexible to adapt to the diversity of relationships that charities need to engage in. Requirements on charities to implement the new mechanism must be in clear and certain terms without ambiguity. Requirements on books and records must be realistic and proportionate to the facts involved in the funding.

- Ease of implementation – From an implementation perspective, the alternative mechanism ideally would be one that is relatively practical to implement, without the need for a complete overhaul of the provisions governing charities in the ITA.

The following are desirable features to be included in the Canadian regime from lessons learned in reviewing Canada's current system and lessons learned from the U.S. and England and Wales regimes:

- Permit grant making – The common thread of the regimes in both the U.S. and England and Wales in permitting charities to make "grants" to foreign organizations in order to further the charitable purposes of the grantor charity is consistent with the common law and is an approach that would be a practical solution to the problem in Canada. Both regimes recognize that the programs being funded are activities of the grantee organizations as opposed to the grantor charity, and as such reflects reality.

- Expenditure control – The focus of both U.S. and England and Wales regimes is on expenditure control, not operational control.

- Due diligence reasonable approach – Both U.S. and England and Wales regimes take a reasonable approach by requiring charities to conduct a reasonable and proportionate level of pre-grant due diligence inquiry, confirm the grant terms in writing, monitor grant progress, and obtain reports from the grantee, without requiring the grantor charity to provide additional onerous reporting, obtain receipts, and constantly directing and controlling the grantee.

- Flexible and principled approach – England and Wales follows a flexible and principled approach, although the approach seems to lack specificity in some respects. In light of the experience of the Canadian charitable sector, being specific on exactly what they is required to comply with would be generally helpful. On the other hand, the U.S. regime is very clear on what charities are required to do, but the requirements are extremely detailed and may not be totally suitable to the Canadian sector's desire for a streamlined process. It would appear that adopting a balanced approach between the U.S. and England and Wales regimes would be the best way forward.

- No overly onerous reporting – The requirement of the U.S. regime to provide detailed reporting in Form 990-PF on each grant would be an inappropriate administrative burden for Canadian charities.

- Positive, informative and educational guidance – The Charity Commission of England and Wales' Grant Funding Guidance is helpful in that it provides flexibility to charities by setting out issues to consider in a tone that is positive, informative and educational. The

Canadian guidance could be modelled after the Grant Funding Guidance and even be improved on.

- U.S. Equivalency determination is overly onerous – Although the equivalency determination mechanism of the U.S. regime provides an alternative for private foundations to make grants to foreign organizations without meeting expenditure responsibility requirements, it is costly and cumbersome, with the need of a legal opinion and extensive information from the grantee. The discretion involved with such a determination would also lead to uncertainty in the sector. This would not appear to be a suitable mechanism for Canada to model after.

The following alternative mechanisms do not seem to be practical and would have limited values in addressing the concerns involving the own activities test and direction and control mechanism:

- The concept of expanding the types of foreign entities that could be registered as qualified donees under subsections 149.1(1) and 149.1(26) of the ITA for granting purposes is not entirely satisfactory because (a) the foreign entity must have received a gift from the Canadian government in the past 24 months and therefore which entities would qualify for status is still very much dependent on funding process of the Canadian government, which may have no correlation to the charitable work of the sector; (b) the registration process is lengthy and cumbersome, and (c) it is not clear whether Parliament would be willing to support an amendment broadening this category of qualified entities, since entitlement to this category was significantly narrowed (as a result of 2012 Federal Budget) to those that are also "carrying on relief activities in response to a disaster, providing urgent humanitarian aid, or carrying on activities in the national interest of Canada."

- The idea of expanding the types of foreign entities that could be registered as qualified donees to include charities that are registered in certain jurisdictions that have effective oversight of charities (such as the U.S. and England and Wales) is also not entirely satisfactory because (a) the ITA would need to be amended to create a new category of qualified donee; (b) setting out "pre-approved" jurisdictions in the ITA would appear to provide endorsements to charities in those jurisdictions; and (c) this mechanism would not be helpful to the vast majority of NGOs in other countries that Canadian charities work with, especially those that wants to fund programs in developing areas, such as in Africa and South America.

As explained above, it would be inappropriate to continue justifying the direction and control mechanism under the ITA as a tool to control and monitor terrorist financing under Canada's onerous anti-terrorism regime because there are two separate regulatory regimes. Therefore, the effectiveness of an alternative mechanism under the ITA to deal with the serious problems associated with the "own activities" test and the corresponding requirements for direction and control should not be confused or conflated with what is required to enforce the anti-terrorism regime. If a conflated justification was in fact to be the policy objective of CRA, then CRA should clearly state that the "own activities" test and direction and control continued to be required of all charities in order to achieve the limited purpose of anti-terrorism compliance for a few charities notwithstanding that no other jurisdiction conflates the two.

(b) *Proposal: Permit Charities to Make Grants*

(i) Proposed Changes – Overview

To address the limitations and concerns involving the "own activities" test in the ITA and CRA's policy requiring charities to exercise "direction and control" when conducting their own activities, it is proposed in general that the ITA and CRA's policies be amended as follows:

(a) The ITA would be amended to remove the "own activities" test and thereby allow charities to operate charitable activities to further their charitable purposes without the need to demonstrate that the activities are their "own activities." CRA's policies be amended to replace the "direction and control" requirements with new "program responsibility" requirements as discussed below ("Program Responsibility Requirements").

(b) Charities would be allowed to make grants to non-qualified donees to further the grantor charity's charitable purposes. The ITA would be amended to deem such grants to be a "charitable activity" of the grantor charity. New CRA policies would be implemented to require all grant making to meet new "grant responsibility" requirements as discussed below ("Grant Responsibility Requirements").

(ii) Grant Making to Non-Qualified Donees with Grant Responsibility Requirements

A New Mechanism

Grant making would be a new mechanism for charities to use their resources. Since charities are already allowed to make gifts to qualified donees, the value and purpose of allowing charities to make grants would be limited to non-qualified donees.

The proposal to allow Canadian charities to make grants to non-qualified donees would require that all grant funds be made to further the charitable purposes of the grantor charity. This would allow charities, both charitable organizations and charitable foundations, to meet the requirements in the ITA to be "operated" exclusively for charitable purposes.[127]

The focus would no longer be on using a charity's resources to operate the charity's "own activities", but on ensuring that a charity's resources, in the form of grant funds, would be used to further the charitable purposes of the grantor charity. When a grant is made, grant funds would be restricted by the grantor charity under a grant agreement to be used by the grantee for the grantee's program that achieves the charitable purpose of the grantor charity. The program on the ground would be recognized as a program of the grantee, not of the grantor as required under the fictional "own activities" test in the ITA.

Deemed Charitable Activity

It is proposed that the ITA would be amended to deem grants to non-qualified donees to be a "charitable activity" of the grantor charity. ITA amendments are reviewed in more detail below.

[127] *Supra* note 4 and note 6.

New Grant Responsibility Requirements

Instead of complying with the current "direction and control" mechanism, charities that make grants would be required to comply with the new Grant Responsibility Requirements explained below (a terminology used for the purpose of this paper).

Not for Qualified Donees

Since the ITA does not currently contemplate Canadian charities making grants to non-qualified donees, current information and resources in the Canadian charitable sector on "grant making" only relate to making grants to qualified donees.[128] These Canadian resources indicate that grant making processes to qualified donees include preparing for the grant; obtaining proposals; making the grant; managing the grant; and closing and evaluating the grant. In order words, for purpose of the ITA, these "grants" are in fact "gifts" to qualified donees subject to restrictions under the current ITA regime. Should the proposal in this paper allowing charities to make grants to non-qualified donees be implemented in Canada, the terminology to be used need to be distinguish between gifts to qualified donees and grants to non-qualified donees. Considering that the proposal will open up new opportunities for Canadian charities to make grants to non-qualified donees similar to other charities in the international context, minor changes in the terminology in the Canadian charitable sector should not be a burden.

Presumably, it may be conceptually possible for charities to be free to make grants, as opposed to gifts, to qualified donees and thereby they would be free to choose which mechanism to use. However, this would be something that would need additional consideration, including how a grant made to a qualified donee would be reported in the T3010 *Registered Charity Information Return* as a gift. Proposed changes to the ITA in this paper are drafted on the assumption that charities would not need to make "grants" to qualified donees using the mechanism proposed in this paper and therefore would be precluded from doing so.

Meaning of "Grant"

The term "grant" is not defined in the *Charities Act 2011* in the U.K. regime. What grant making involves is explained in various guidances of the Charity Commission reviewed above. In the U.S., grant making is regulated by complicated provisions in section 4945 of the Code and Treas. Reg. section 53.4945-5 in the context of grant making by private foundations. What "grant" means is set out in Treas. Reg. section 53.4945-4(a)(2), that involves a list of what payments are and are not accepted as grants.[129] In the U.S., it is commonly accepted that while "it would be easy to

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[128] Patrick Johnston, "Good Grantmaking: A Guide for Canadian Foundations" (Revised 2015) Philanthropic Foundations Canada, online: <https://pfc.ca/wp-content/uploads/2018/01/pfc-good-grantmaking-guide-2015-full-en.pdf);>; Philanthropic Foundations Canada, "A Portrait of Canadian Foundation Philanthropy," (September 2017), online: <http://pfc.ca/wp-content/uploads/2018/01/portrait-cdn-philanthropy-sept2017-en.pdf).);>; Philanthropic Foundations Canada, "Snapshot of Foundation Giving in 2015" Nov(November 2017), online: <http://pfc.ca/wp-content/uploads/2018/05/pfc-snapshot-giving-2015.pdf);>; Philanthropic Foundations Canada, "Assets & Giving Trends of Canada's Grantmaking Foundations," (September 2014 (),), online: <http://pfc.ca/wp-content/uploads/2018/01/assets_giving_trends_sept2014_web.pdf) > .

[129] The definition of grants in Treas Reg § 53.4945-4(a)(2) applies to both grants to individuals in Treas Reg § 53.4945-4 and grants to organizations in Treas Reg § 53.4945-4 as follows:

> (2) "Grants" defined. For purposes of section 4945, the term "grants" shall include, but is not limited to, such expenditures as scholarships, fellowships, internships, prizes, and awards. Grants shall also include loans for purposes described in section 170(c) (2) (B) and "program related investments" (such as investments in small businesses in central cities or in businesses which assist in neighborhood renovation). Similarly, "grants" include such expenditures as payments to exempt organizations to be used in furtherance of such recipient organizations' exempt purposes whether or not such payments are solicited by such recipient organizations. Conversely, "grants" do not ordinarily include salaries or other compensation

think of grants as gifts, grants are, in fact, contracts: grantors make grants for particular purposes and do not tend to expect the funds ever to be returned" unless there is a breach of the grant terms.[130]

However, it is proposed that a new definition for "grant" be inserted in the ITA to clarify what it means for purpose of ITA and how it differs from gift making by Canadian charities. In this regard, it is proposed that "grant" be defined to mean "a transfer of resources by a registered charity, subject to restrictions imposed by the registered charity, to a non-qualified donee for a charitable activity of the non-qualified donee in order to achieve the charitable purpose of the registered charity."

The structuring and monitoring of the grant would be governed by the Grant Responsibility Requirements explained below, such as requiring the grantee to have specific duties, including budget reports, progress reports, and return of unused grant funds. The relationship between the grantor and the grantee is usually that of a contractual relationship, with consequences if the terms of the grant are breached.

In a sense, a "grant" can be viewed as a restricted gift for common law purposes. Since the term "gift" for ITA purposes is different from the meaning at common law, the term "grant" therefore can carry a different meaning under the ITA and under common law.

The term "gift" is not defined in the ITA. At common law, in order to qualify as a gift, property must be transferred voluntarily with an intention to make a gift and without consideration or anticipation of benefit.[131] It is possible for a donor to set out the conditions and restrictions to be attached to a gift when the gift is made, such as restrictions on the charitable purpose for which the gift must be applied, and restrictions on the recipient to hold the gift for a period of time before disbursing it. These restrictions must be imposed at the time when the gift is made. It is not open for the donor to impose additional restrictions or to remove the restrictions at a later time.[132]

However, the definition of a gift at common law is different from the definition for a valid gift under the ITA for income tax purposes. For ITA purposes, the split receipting rules allow a

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to employees. For example, "grants" do not ordinarily include educational payments to employees which are includible in the employees' incomes pursuant to section 61. In addition, "grants" do not ordinarily include payments (including salaries, consultants' fees and reimbursement for travel expenses such as transportation, board, and lodging) to persons (regardless of whether such persons are individuals) for personal services in assisting a foundation in planning, evaluating or developing projects or areas of program activity by consulting, advising, or participating in conferences organized by the foundation.

[130] Rachel Gillette, "The Making of General Support Grants within the Confines of Expenditure Responsibility: A Deviation from Standard Legal Interpretation", 45 Fordham Urb LJ 1295 (2018).

[131] Kathryn Chan, "The Perils of Federalizing the Common Law: A Case Study of the ITA Gift Concept", 50 UBC L Rev 579 (2017); Patrick J Boyle, "Gifts, Partial Gifts, Split Receipting, and Valuations", *The Philanthropist*, vol 20, No. 3, 205.

[132] Terrance S Carter, "Donor-Restricted Charitable Gifts: A Practical Overview Revisited II" (2006), online: *Carters Professional Corporation* <http://www.carters.ca/pub/article/charity/2006/tsc0421.pdf>. See also Terrance S Carter, "Considerations in Drafting Restricted Charitable Purpose Trusts" (2017), online: *Carters Professional Corporation* <http://www.carters.ca/pub/seminar/charity/2017/step/StepPaper2017.pdf>, and R. Jane Burke-Robertson, Terrance S. Carter & Theresa L.M. Man, *Corporate and Practice Manual for Charities and Not-For-Profit Corporations,* "Chapter 17: Issues in Drafting Restricted Charitable Purpose Trusts" (Toronto, ON: Thomson Reuters, 2013) (loose-leaf updated 2019, release 2019-7).

donation receipt to be issued for the receiptable portion of a gift ("eligible amount") where the fair market value of the gift exceeds an advantage received that is related to the gift.[133]

Similarly, the word "gift" is also not defined in U.S. or U.K. where grant making is permitted. Under the ITA, charities are only permitted to make gifts to qualified donees. Since it is proposed that charities be permitted to make "grants" to non-qualified donees, there is no need to define the word "gift" in the ITA in order to permit grant making by charities.

Grant vs Contract for Services

Another issue that a system that permits grant making needs to distinguish is whether a transfer of funds is a grant or a contract for services and what, if any, would be the consequences of such a distinction. Interestingly, both the U.S and the U.K. regimes involve consideration of this issue.

In the U.S., proper identification between the two types of transactions is important to ensure compliance with the grant making requirements under the Code and related legal requirements. For example, certain types of payments are not accepted as "grants".[134]

A grant is generally recognized as a transfer where the grantor does not receive return value for its own use or benefit. Examples of grants may include a payment to a charity to operate a charitable program, or a program-related investment to a business to have it employ disadvantaged person. On the contrary, a contract for services generally involves a transfer where the transferor (payor) receives return value for its own use or benefit, such as a report or study that is given back to the payor. Examples of contracts for services may include hiring consultants or other resource persons to prepare a report for the payor. It has been pointed out the transferor in a contract for services may maintain some significant, direct involvement in the activities funded, such as the right to review the work done or make suggestions. It is observed that the line between a grant and a contract can sometimes be blurry, such as the example of a contract between a private foundation and a public charity to conduct long-term project evaluation or study, where the public charity often engages in project evaluations for others within its field of interest, sometimes using grant funds and sometimes on a contract basis.[135]

The U.K. regime also involves similar difficulty in distinguishing between a grant and a contract for services. Similar to the U.S., proper identification between the two is important to ensure compliance with the grant making requirements, but there is also significant difference in terms of the application of value-added tax ("VAT"), procurement requirements, and other fundamental features of the transaction.

Generally, in the U.K. regime, a grant involves funds freely given and the grantor receives nothing in return. To qualify as a grant, the grantee must use the grant funds to further the purposes of the grantor charity. It has been observed that "the assumption underlying a grant is that the recipient needs subsidy. The grant funder is therefore subsidising a service it considers necessary, but which the recipient does not otherwise have the resources to deliver on a self-sustaining basis at the required standard." In this regard, it is noted that "unless the grant agreement is a deed,

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[133] *Supra* note 131.

[134] *Supra* note 106 and note 107.

[135] Gene Takagi, "Grantmaking by Public Charities" (28 May 2019), US Neo Law Group, online: <http://www.nonprofitlawblog.com/grantmaking-by-public-charities/>; The Mott Foundation, "Distinguishing between 'grants' and 'contracts for services'", online: <https://www.mott.org/grantee-resources/usa-patriot-act-and-re-granting-compliance/distinguishing-grants-contracts-services/> .

there is no obligation to pay" because it is entirely up to the grantor charity to choose to make a grant, rather than a grantee having a right to demand a grant. A grant may be eligible to be a Gift Aid payment if the recipient is a charity and, most importantly, a grant is not subject to VAT. [136]

On the other hand, in the U.K. regime, a contract for services involves a mutual bargain with consideration paid, where the "assumption underlying a contract is that the recipient is a viable and self-sustaining organisation" and the transfer is a purchaser "buying an agreed service, at an agreed standard, for an agreed price." As such, a contract for services "contains reciprocal obligations and the payment may be subject to VAT, depending on the service being supplied." However, Gift Aid is not available for payments made under a contract for services and European Commission rules on public procurement will apply.[137]

These distinguishing features underscores how the contract for services mechanism accepted by CRA in the "direction and control" regime in the Canadian regime is ill suited for Canadian charities to engage intermediaries to operate their charitable programs.

Under the proposal of grant making, charities would also need to be aware of the need to distinguish whether a particular arrangement with a non-qualified donee should be structured as a grant through a grant arrangement that meets Grant Responsibility Requirements, or be structured as a contract for services governed by commercial law principles. It would be helpful that CRA's policy on Grant Responsibility Requirements would also provide guidance on distinguishing features between the two to help charities to make a decision in this regard.

(iii) Gifts to Qualified Donees

There would be merits to continue permitting charities to make gifts to qualified donees.

There is no need to *replace* this with grant making by requiring transfers to qualified donees to be in the form of the grant making being proposed. As well, since the concept of gift making to qualified donees is fundamental to many provisions in the ITA, to replace this with grant making would require major overhaul of many ITA provisions, which may cause unnecessary road block to implement in a timely manner an alternative mechanism to solve concerns involving the "own activities" test and direction and control mechanism.

(iv) Operate Charitable Activities and Program Responsibility

Charities should continue to be permitted to use their resources to operate charitable activities to achieve their charitable purposes by their employees, directors and/or volunteers. These would be activities that are "truly" activities of the charities themselves. The activities could be located in Canada or outside Canada. Examples of a charity's activities in this manner might include a local church in Toronto conducting a summer Bible camp in northern British Columbia, or a local poverty relief charity in Calgary operating a feeding and soup program for school children in a village in Kenya.

As well, there would also be situations where charities would need to operate charitable activities "on the ground" to achieve their charitable purposes with the help of or in conjunction with third party intermediaries. It is proposed that the ITA be amended to remove the "own activities" test,

[136] The Longley and Bill Lewis, Bates Wells & Braithwaite LLP, Are you Receiving a Grant or Delivering a Contract?, The Institute of Chartered Accountants in England and Wales, online: <https://www.icaew.com/technical/charity-and-voluntary/tax/are-you-receiving-a-grant-or-delivering-a-contract> .

[137] *Ibid*.

thereby allowing charities to operate charitable activities without the need to demonstrate that the activities are their "own activities." Proposed ITA amendments are explained in more detail below.

In this regard, in the above example where a local poverty relief charity in Calgary wants to operate a feeding and soup program for school children in a village in Kenya, the charity might want to engage a person or a local village to help operate the program on the ground in Kenya. Since this would involve *bona fide* programs that the charity can call its "own" (not the restrictive, unrealistic, artificial, and fictitious contortion under the current direction and control mechanism to turn a program of another entity to become a program of the Canadian charity), it would be reasonable for the charity to be required to maintain proper control and monitoring requirements on the program on the ground because it would be the charity that was actually carrying out the program.

Since these programs would be actual programs of the charity, it would not be appropriate to apply the Grant Responsibility Requirements to the charity. However, where intermediaries are used, new Program Responsibility Requirements would need to be used to replace the direction and control mechanism. These requirements would be more onerous than the new Grant Responsibility Requirements to be put in place for grants. These requirements are reviewed further below.

Another attractive feature of continuing to allow charities to operate their own programs with intermediaries is that charities that are engaging in these programs upon the amendment of the ITA may choose to (i) continue their arrangement with the intermediaries that are non-qualified donees if it suits their purpose, or (ii) convert their arrangements into grants to non-qualified donees under the new grant regime.

(v) CRA Policy – Grant Responsibility Requirements

Instead of direction and control requirements, charities that make grants to non-qualified donees would be required to comply with certain obligations to ensure accountability by charities and promote trust by the public in the sector. For the purpose of this paper, the obligations are referred to as Grant Responsibility Requirements to distinguish them from the "expenditure responsibility" requirements of the U.S. regime. Although elements of Grant Responsibility Requirements would be modelled after the U.S. regime, it is intended that the Canadian mechanism would be a hybrid of those used in the U.S. and England and Wales in being less prescriptive than the U.S. system while the CRA guidance would employ the tone and language similar to the England and Wales regime as being positive, informative and educational; and an approach that is practical, flexible and principled.

Another key approach of the Grant Responsibility Requirements is that charities would be required to conduct a reasonable and proportionate level of due diligence and monitoring to ensure responsible usage of the grant funds by the grantee to achieve the grantor charities' charitable purposes.

With the implementation of new Grant Responsibility Requirements that would be modelled after the U.S. and U.K. systems, charities would finally be given the freedom to enjoy what was promised by CRA in the 1990 Discussion Paper explained above to enter into "[p]erformance contracts and other arrangements which secure 'expenditure responsibility' by the Canadian

charity in an acceptable manner" where "[s]implified arrangements will be developed in these circumstance to reduce the paper burden."[138]

The focus would no longer be on using a charity's resources to operate the charity's own activity, but on ensuring that the charity's resources, in the form of grant funds, would be used to further the charitable purpose of the charity. When a grant is made, the program on the ground would be recognised as a program of the grantee but carried out to further the charitable purpose of the charity.

The same Grant Responsibility Requirements would apply regardless of whether the grantees are located in Canada or outside Canada. As such, there would be no need for two CRA Guidances (i.e., CRA Foreign Activities Guidance and CRA Domestic Activities Guidance). Instead, they would be replaced with one CRA guidance on "grant making" to non-qualified donees.

Key elements of the Grant Responsibility Requirements would involve pre-grant due diligence, written grant terms, proportionate risk-mitigation, proper monitoring, appropriate reporting by grantee, and appropriate reporting by the charity to CRA. Compliance with these obligations would allow the charity to ensure that the desired charitable purposes would be achieved. Each of these are further described below:

Pre-grant Due Diligence

The charity would be required to conduct an internal pre-grant process that would include having a clear understanding of the charity's own charitable purposes and putting in place appropriate systems and procedures for making decisions about grants. This could be a process that the charity would conduct on an annual basis and be updated from time to time as necessary. The purpose of this would be to ensure that the charity has the appropriate internal basis and knowledge to make an informed grant before the charity considers any specific grant. For a small organization, this internal process could be a rather simple process.

The charity would also be required to take reasonable steps of due diligence for the pre-grant inquiry concerning the potential grantee. The purpose of the inquiry would be to enable the charity to have a reasonable assurance that the grantee has the capacity of the grantee to use the grant for the charitable purposes designated by the charity.

The scope of the inquiry could vary from case to case depending on grant size, grant period, purpose of grant, complexity of grant, as well as prior knowledge and working experience that the grantor has with the grantee. Basic aspects to be included in the pre-grant inquiry would include: capacity assessment of the grantee (including its identity, history, past track records, key personnel, experience and expertise to deliver the project, organizational structure, staff turnover, and any knowledge which the charity has about the grantee, or other information which is readily available concerning the grantee), as well as a terrorism, reputational, and reference check. Where other factors are warranted (such as large grant size, long term grants, complex grant structure), additional inquiry might be necessary (such as site visits). To assist the charity, a basic template of pre-grant checklist could be provided by CRA as a reference tool that the charity could customize for use.

As indicated above, it would be helpful to provide guidance on distinguishing features between a grant and a contact for services to help charities decide whether a particular arrangement with a

[138] 1990 Discussion Paper, *supra* note 42.

non-qualified donee should be structured as a grant through a grant arrangement that meets Grant Responsibility Requirements, or be structured as a contract for services governed by commercial law principles.

Written Grant Terms

The charity and the grantee would be required to confirm the grant terms in writing. It could be in the form of a grant agreement, or a term sheet for small or low risk grants. The terms would need to include the following basic elements in requiring the grantee to agree to: use the grant for the charitable purposes stated in the agreement; repay any portion of the grant not used for the purposes of the grant; submit full and complete periodic (such as quarterly, semi-annual or annual), reports on the manner in which the funds are spent and the progress made; and maintain records of receipts and expenditures and to make its books and records available to the charity upon request. The grant terms should also address consequences in the event if the terms were breached (including the return of unused grant funds, and reimbursement of grant funds inappropriately spent by the grantee not in accordance with the grant terms), and appropriate protection of the charity's intellectual property rights and reputation. For complex grants, the grant agreement would likely be more detailed.

Proportionate Risk-Mitigation and Monitoring

The charity would be required to put in place a reasonable, appropriate and proportionate monitoring framework for each grant. The framework required would depend on the value of the grant and the charity's assessment of the risks. Resources could be provided to charities on how to identify and manage risks; and would give practical steps and guidance on carrying out proper monitoring and verification of proper use of funds by the grantee. Examples of monitoring tools and monitoring checklist would be helpful.

The guidance could flag consideration factors for situations where extra care and scrutiny would be required. Examples could include whether the country is unstable, local employment rules, protection of the charity's staff and beneficiaries, risk of involvement with terrorism, tracking money and resources, guarding against fraud and financial crime, money transfer risks, and insurance issues.

Appropriate Reporting by Grantee and Record Keeping

The charity would need to obtain financial and narrative reports from the grantee on: the use of the funds; compliance with the terms of the grant; and progress made by the grantee. Reports could be provided on a periodic basis, such as quarterly, semi-annual or annual, depending on the complexity of the grant. The grantee would be required to maintain records of receipts and expenditures and to make its books and records available to the charity upon request. However, the grantee would not be required to provide the charity with receipts, invoices and vouchers on how the grant funds are spent unless the required by the charity for monitoring purposes.

Appropriate Reporting by Charity to CRA

There would be appropriate reporting of the grants in the T3010 *Registered Charity Information Return*. Examples would be requiring the grantor charity to report in a separate schedule to the T3010 on grants made in the fiscal period in some manner, such as listing of the number of grants made, names of grantees, country location of grantees, purposes of grants, whether a grant agreement is in place, as well as start and end dates of grants. The requirement of the U.S. regime on requiring detailed reporting on each grant in Form 990-PF would be unnecessarily onerous for

Canadian charities since completion of detailed schedules in the T3010 is not required for the current regime.

(vi) CRA Policy – Program Responsibility for Charitable Activities

As indicated above, for charities that operate charitable activities through their own employees, directors and/or volunteers, or through intermediaries, they would be required to conduct reasonable and proportionate levels of due diligence and monitoring to ensure responsible usage of their resources on charitable activities themselves and by their intermediaries.

Since these are not grants, it is proposed that charities be required to meet new Program Responsibility Requirements on these activities (instead of the direction and control mechanism). These requirements would be more onerous than the new Grant Responsibility Requirements to be put in place for grants.

In this regard, elements of the Program Responsibility Requirements would be similar to the Grant Responsibility Requirements, but there would be key differences. For example, the charity would be entitled to request the intermediary to provide receipts, invoices and vouchers because these are actual activities of the charity itself (whereas a grantor charity would not ask for these from a grantee). Another example might be that ownership of by-products generated from the activities would be owned by the charity, such as intellectual property of a research project or a curriculum of a book unless there was a cogent reason not to do so (whereas the grantee could own the by-products as long as there is assurance in the grant agreement that the grantee would use the by-products of the grant to further the charitable purposes of the grantor charity).

(c) *ITA Amendments*

As indicated above, it is proposed that the ITA be amended by removing the "own activities" test by changing the reference to "… charitable activities carried on by the organization itself" to simply "charitable activities." In this regard, (i) charitable organizations would still be required to devote all of their resources to charitable activities; (ii) charitable status of all registered charities would still be revoked if they fail meet their disbursement quota obligations on charitable activities or by making gifts to qualified donees; or (iii) be revoked if they make a disbursement by way of a gift, other than a gift made, in the course of charitable activities.

Arguably, it is possible to go one step further by amending the ITA to remove the requirement on charities to carry on "charitable activities" altogether in order to better reflect the focus on charities furthering charitable purposes rather than charitable activities.[139] However, to do so will require much more extensive amendments to the ITA, which may not be attractive to the legislators at the present time. Unless the legislators were willing to undertake a significant revamp the ITA in this manner, such extensive changes may cause unnecessary roadblocks to a timely solution to problems associated with the own activities test regime.

Similarly, by amending the ITA to deem grant making non-qualified donees be a "charitable activity" would greatly simplify the required changes to the ITA. This would be similar to the approach of the ITA amendments that replaced the prohibition on political activities with the empowerment on charities to carry on "public policy dialogue and development activities" by

[139] *Vancouver Society of Immigrant and Visible Minority Women v MNR*, *supra* note 30; and Juneau, *supra* note 18.

deeming those activities to be "charitable activities."[140] Otherwise, instead of utilizing this deeming approach, the other approach to allow grant making would require more extensive ITA changes to allow charities to expend their resources in a third way, namely through grant making, in addition to making gifts to qualified donees and on charitable activities, which extensive changes to the ITA also may not be attractive to the legislators.

As such, it is proposed that the following ITA provisions be amended, together with other consequential amendments where required:

- Amend the definition for "charitable organization" in subsection 149.1(1) by deleting the words "carried on by the organization itself" as follows:

> "charitable organization", at any particular time, means an organization, whether or not incorporated,
>
> (a) constituted and operated exclusively for charitable purposes,
>
> (a.1) all the resources of which are devoted to charitable activities ~~carried on by the organization itself~~,
>
> (b) … [no income to benefit members etc]
>
> (c) … [50% arm's length test]
>
> (d) … [control test]

- Amend the definitions for "charitable purposes" and "charitable activities" in subsection 149.1(1) by adding the words "and making grants to non-qualified donees" as follows:

> "charitable purposes" includes the disbursement of funds to a qualified donee <u>and making grants to non-qualified donees</u>
>
> "charitable activities" includes public policy dialogue and development activities carried on in furtherance of a charitable purpose <u>and making grants to non-qualified donees</u>;

- Similarly, adding the words "and a grant to a non-qualified donee" in subsection 149.1(10)

> (10) Deemed charitable activity – An amount paid by a charitable organization to a qualified donee, <u>and a grant to a non-qualified donee,</u> that is not paid out of the income of the charitable organization is deemed to be a devotion of a resource of the charitable organization to a charitable activity carried on by it.

[140] The ITA was amended through Bill C-86, *Budget Implementation Act, 2018, No. 2*, *supra* note 5, which received Royal Assent on December 13, 2018, online: Government of Canada <https://www.fin.gc.ca/n18/18-072-eng.asp>.

- Inserting new subsection 149.1(10.2) that parallels the wording in subsection 149.1(10.1) regarding public policy dialogue and development activities as follows:

> (10.2) Grants made by an organization, corporation or trust in support of its stated purposes shall be considered to be carried on in furtherance of those purposes and not for any other purpose.

- Inserting new section a new definition for "grants" in subsection 149.1(1) as follows:

> "Grant" means a transfer of resources by a registered charity, subject to restrictions imposed by the registered charity, to a non-qualified donee for a charitable activity of the non-qualified donee to achieve the charitable purpose of the registered charity.

- Amend subsection 149.1(2) regarding the revocation of registration of charitable organizations by deleting the words "carried on by it" as follows, with similar changes also be made to subsections 149.1(3) and (4) regarding the revocation of registration of public foundations and private foundations:

> (2) Revocation of registration of charitable organization – The Minister may, in the manner described in section 168, revoke the registration of a charitable organization for any reason described in subsection 168(1) or where the organization
>
> (a) carries on a business that is not a related business of that charity;
>
> (b) fails to expend in any taxation year, on charitable activities ~~carried on by it~~ and by way of gifts made by it to qualified donees, amounts the total of which is at least equal to the organization's disbursement quota for that year; or
>
> (c) makes a disbursement by way of a gift, other than a gift made
>
> (i) in the course of charitable activities carried on by it, or
>
> (ii) to a donee that is a qualified donee at the time of the gift.

- Similarly, deleting the words "carried on by it" when referencing "charitable activities" in the following ITA provisions:

  Paragraph 149.1(4.1)(d) regarding revocation of registration of registered charity

  Subsection 149.1(5) regarding reduction of disbursement quota

  Subsection 149.1(6) Devoting resources to charitable activity by charitable organizations

Subsection 149.1(20) regarding disbursement excess

Subsection 149.1(21) regarding definition of “disbursement excess

Subsection 188.1(12) regarding gifts between arm’s length charities

Subsection 188(1.1) paragraph (b) under B regarding revocation tax

Paragraph 188(6.2) (a)(i) regarding reduction of revocation tax liability

- Similarly, deleting the words “carried on by the charity” when referencing “charitable activities” in paragraph 188.1(5)(b)(i) regarding the meaning of undue benefits.

6. Conclusion

As has been explained in this paper, the current CRA policy on direction and control to meet the “own activities” test under the ITA is outmoded, impractical, inefficient, unpopular, and built upon the fiction that everything that a charity does through a third party intermediary must be structured as the activity of the charity itself when the reality is that the activity is, more often than not, intended to be the activity of the recipient third party. As a result, the current direction and control regime has created a fictitious counter reality that charities have extreme difficulty in complying with and which causes charities to become exposed to unnecessary liability through the imposition of agency and similar relationships that often create unintended vicarious liability for the charity. In reality, what is often intended is no more than a grant relationship where the resources of a charity are transferred to support the activities of the recipient, subject to restrictions, in order to accomplish the charitable purpose of the charity, rather than having to be structured as the activities of the charity.

With the charitable sector having been successful in reforming the disbursement quota regime in 2010 and the political activity regime in 2018, and given the recent Senate Report, the time is right for the charitable sector to move forward with reform of the direction and control regime that has been based upon an outdated concept of “its own activity” in the ITA that no longer serves a legitimate tax policy. This paper attempts to provide a practical alternative to consider which in general terms involves (1) the removal of any reference to “own activity” in describing “charitable activities” in the ITA undertaken to pursue the purpose of the charity, (2) the deeming of grants to non-qualified donees for activities of the recipient grantee in achieving the charitable purposes of the grantor charity to be activities of the grantor charity, (3) the implementation of a CRA policy on Grant Responsibility Requirements that would reflect the best of the U.S. expenditure responsibility test and grant making requirements in England and Wales, and (4) the implementation of a CRA policy on Program Responsibility Requirements to provide practical guidelines for charities that wish to undertake their own programs by working through or in conjunction with third parties that are non-qualified donees.

As indicated in the introduction to this paper, is not the intent of the authors to propose changes that offer a long term solution for the charitable sector by providing a modern, coherent and empowering framework by revamping the income tax regime governing registered charities. Such an expansive degree of reform would take years to accomplish. Instead, it is hoped that the proposal set out in this paper would offer an interim practical solution to the dilemma faced by charities by requiring as little legislative change as possible, while leaving the broader restructuring of the framework to be accomplished at a later time.

In this regard, it is hoped that the proposal contained in this paper will form the basis for a dialogue as well as a consensus between CRA, the Department of Finance and the charitable sector concerning how to move forward at this time.

It is also hoped that the proposal would lead to changes that would ensure that the regulatory environment for registered charities in Canada involving direction and control in the interim will become one that is sensitive to the practical realities that charities face and avoids unnecessary restrictions that currently impede charities in the work that they are called to do internationally and domestically when working with non-qualified donees.

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