

INTERMEDIATE PENALTIES AND SANCTIONS IN SEPTEMBER 16, 2004, DRAFT AMENDMENTS TO THE *INCOME TAX ACT*

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A. INTRODUCTION

On September 16, 2004, the Department of Finance (the “Department”) released draft amendments (“the “September 2004 Amendments”) to the *Income Tax Act* (the “Act”) that, when adopted, will implement the initiative of the Federal Government in rewriting the tax rules concerning the taxation and administration of charities as set out in the Federal Budget that was announced on March 23, 2004 (the “2004 Budget”). Details regarding the 2004 Budget are summarized in our *Charity Law Bulletin* No. 41 dated March 30, 2004.¹ In general, these initiatives include changes to the Act in the following areas:

- ◆ No trading in charitable donations;
- ◆ New intermediate sanctions and related matters, such as the transfer of assets upon revocation of charitable status and new rules regarding the annulment of registered charities;
- ◆ New appeal regime for registered charities, including a new internal reconsideration process and the appeal of taxes and penalties to the Tax Court of Canada;
- ◆ Transparency and accessibility of information concerning registered charities, including release of more information to the public concerning registered charities and organizations that are denied

¹ *Charity Law Bulletin* No. 41 dated March 30, 2004 is available on our website at www.charitylaw.ca.

registration, inclusion of more information on official tax receipts, and increased information on the website of Canada Revenue Agency (“CRA”); and

- ◆ New disbursement quota rules.

Since the changes to the Act that would give effect to the above are voluminous, these proposed amendments are covered in a series of four *Charity Law Bulletins*. This is the first in this series of *Charity Law Bulletins*. Only those proposed amendments that relate to intermediate sanctions are summarized in this *Charity Law Bulletin*. It is important to note that the proposals that are set out in the 2004 Budget should be read in addition to the February 27, 2004 revised draft technical amendments, which were commented on in *Charity Law Bulletin* No. 40 dated March 29, 2004,² as well as in a paper by the authors entitled “Recent Changes to the *Income Tax Act* and Policies Relating to Charities and Charitable Gifts (current to March 1, 2004).”³

B. INTERMEDIATE SANCTIONS AND RELATED MATTERS

1. Intermediate taxes and penalties

The 2004 Budget introduced a new section 188.1 to put in place intermediate taxes and penalties to address the concern that the only recourse that CRA could impose on a registered charity that did not comply with the requirements of the Act was to revoke its status as a registered charity. The Explanatory Notes to the September 2004 Amendments state that these penalties on registered charities are “more appropriate than revocation for unintended or incidental breaches of the Act,” and that these penalties apply in respect of “activities that charities are not permitted to undertake.” The Explanatory Notes also explain that “some penalties are progressive, increasing in severity for repeat infractions within a period of 10 years.” In the 2004 Budget, there was no mention of the length of the period that would be used in assessing penalties for repeat offences. In the September 2004 Amendments, a ten year period is introduced in this regard. However, it would appear that using a ten year period may seem harsh, particularly where there could be a whole new regime running a charity with no knowledge of past transgressions. One can easily envision situations in which completely unrelated staff at different times, make similar mistakes in good faith. A shorter period may be more appropriate, in the absence of some form of culpable conduct.

² *Charity Law Bulletin* No. 40 dated March 29, 2004 is available on our website at www.charitylaw.ca.

³ The paper “Recent Changes to the *Income Tax Act* and Policies Relating to Charities and Charitable Gifts (current to March 1, 2004)” was presented to the Society of Estate and Trust Practitioners on March 4, 2004 is available on our website at www.charitylaw.ca.

The Explanatory Notes also clarify that these sanctions apply “notwithstanding the discretion of the Minister of National Revenue to revoke the registration of a charity in respect of the same activities.” These sanctions include taxation of gross revenue derived from business activities, suspension of tax-receipting privileges, monetary penalties, and taxation of gifts and transfers to other registered charities. These changes are introduced concurrently with amendments to section 189 of the Act, which introduces a process for assessment and dispute resolution.⁴ These measures will apply in respect of taxation years that begin after March 22, 2004. The proposed amendments to the Act in this regard can be summarized as follows:

a) Carrying on business

Subsection 188.1(1) imposes a penalty equal to 5% of the gross income earned from any business in a taxation year if (a) the business is carried on by a private foundation, or (b) the business is “not a related business in relation to” a charitable organization or a public foundation in question. Upon a repeat infraction within ten years of a previous infraction under either subsection 188.1(1) or 188.1(2), the penalty is increased to 100% of the gross revenue earned from the applicable businesses in a taxation year. In other words, all repeat infractions within ten years are subject to 100% penalties. In addition, upon repeat infractions, subsection 188.2(1) provides that the registered charity’s tax-receipting privileges shall be suspended.⁵

b) Control of corporation by a charitable foundation

Pursuant to paragraph 188.1(3)(a), if a “charitable foundation” (i.e. either a public foundation or a private foundation) acquires control over a corporation “within the meaning of subsection 149.1(12)” of the Act, then the foundation would be subject to a penalty that is equal to 5% of the dividend received by the foundation in a taxation year during the period when the corporation is so controlled by the charity. The Explanatory Notes explain that if the foundation either “continues to control the corporation or has again acquired control of a corporation” within ten years of a previous infraction under either paragraph 188.1(3)(a) or paragraph 188.1(3)(b), then the penalty will be equal to 100% of the dividend received pursuant to paragraph 188.1(3)(b).

⁴ See *Charity Law Bulletin* No. 56 dated October 31, 2004 for a detailed explanation of changes to the Act in this regard.

⁵ See details in section B.2 below regarding the procedures required in order to suspend this privilege.

c) Conferment of undue benefits

Paragraph 188.1(4)(a) imposes a penalty equal to 105% of any “undue benefit” conferred by a registered charity on any person. Pursuant to paragraph 188.1(4)(b), the penalty is increased to 110% of the amount of undue benefit conferred upon repeat infractions within ten years. In addition, upon repeat infractions, subsection 188.2(1) also provides that the registered charity’s tax-receipting privileges shall be suspended.⁶

“Undue benefit” is a new term under the Act and is broadly defined under subsection 188.1(5). Pursuant to subsection 188.1(5), “undue benefit” includes the following:

- a disbursement by way of a gift⁷; and
- the amount of any part of “income, rights, property or resources” of the charity that is “paid, payable, assigned or otherwise made available for the personal benefit of any person”:
 - (1) who is a “proprietor, member, shareholder, trustee or settlor” of the charity; or
 - (2) who has “contributed or otherwise paid into the charity more than 50% of the capital of the charity,” or
 - (3) who “deals not at arm’s length with a person” mentioned in (i) or (ii) above, or with the charity.

The benefit may be conferred by the charity. The benefit may also be conferred by “another person, at the direction or with the consent of the charity,” that the charity would otherwise have a right to that benefit.

However, an undue benefit does not include a disbursement or benefit that is:

- i) an amount that is “reasonable consideration or remuneration” for “property acquired by or services rendered to” the charity; or
- ii) a gift made or a benefit conferred “in the course of a charitable act in the ordinary course of the charitable activities carried on by the charity, unless it can reasonably be considered that the eligibility of the beneficiary for the benefit relates solely to the relationship of the beneficiary to the charity,” or
- iii) a gift to a qualified donee.

⁶ See details in section B.2 below regarding the procedures required in order to suspend this privilege.

⁷ But see explanation below regarding exception in paragraph 188.1(5)(c) exempting a gift to a qualified donee.

Paragraph 188.1(5)(c) provides that an undue benefit includes a disbursement by way of a gift but does not include a gift to a qualified donee. In other words, a gift to a non-qualified donee would be within the meaning of undue benefit. The 2004 Budget indicates that a gift that is restricted under subsections 149.1(2), (3) or (4) of the Act would be subject to a 105% tax on the amount of undue benefit, and 110% tax on the amount of undue benefit and suspension of tax-receipting privileges. Although no specific reference in this regard is made in the September 2004 Amendments, it would appear that the proposal in the 2004 Budget is implemented through paragraph 188.1(5)(c).

This definition of “undue benefit” is so broad that it would include a benefit conferred by the charity or by a third party and may lead to unintended results. For example, the broad wording of paragraph 188.1(5)(b) would seem to create an undue benefit in a situation where a donor to a religious charity, such as church, who is also a member, has a daughter who is to be married in the church but whose eligibility to be married in the church is conditional upon the daughter becoming a member in that church. It is hoped that this definition would be amended before it is enacted in order to ensure that unintended results are not caught.

d) Failure to file information

Pursuant to subsection 188.1(6), a penalty of \$500 will be imposed on a charity that fails to file or is late in filing the annual information return required under subsection 149.1(14) of the Act for a taxation year. The penalty is the same for repeat infractions.

e) Incorrect information on official donation receipts

Subsection 188.1(7) imposes a penalty equal to 5% of the amount reported on an official donation receipt as representing the amount in respect of which a taxpayer may claim a deduction under subsection 110.1(1) or a credit under subsection 118.1(3), if the information shown on the receipt is not in accordance with the Act or the *Income Tax Act Regulations*. Pursuant to subsection 188.1(8), the penalty upon repeat infractions within ten years is increased to 10% of the amount shown on the receipt. In this regard, concurrent with the introduction of subsections 188.1(6) and (7), it is proposed that sections 3501 and 3502 of the *Income Tax Act Regulations*

be amended to require that official donation receipts issued after 2004 include the current internet address of CRA.

f) False information on official donation receipts

Subsection 188.1(9) of the Act imposes a penalty equal to 125% of the amount shown on a receipt “issued by, on behalf of or in the name of another person,” on a person who “makes or furnishes, participates in the making of or causes another person to make or furnish a statement” on the said receipt that the person “knows, or would reasonably be expected to know but for circumstances amounting to culpable conduct (within the meaning assigned by subsection 163.2(1)), is a false statement (within the meaning assigned by subsection 163.2(1)).”⁸ If the person is “an officer, employee, official or agent” of a registered charity, then the penalty may be imposed on the registered charity. Subsection 188.1(10) provides that if a person is liable for penalties under both section 163.2 and subsection 188.1(9) in respect of the same statement, then the penalty is limited to the greater of those two penalties. In addition, if the total penalty for a taxation year exceeds \$25,000 under subsection 188.1(9), then subsection 188.2(1) provides that the registered charity’s tax-receipting privileges shall also be suspended.⁹

g) Delay of expenditure

Subsection 188.1(11) imposes a penalty equal to 110% of the fair market value of property transferred from one registered charity to another registered charity by way of a gift where it “may reasonably be considered that one of the main purposes for the making of the gift was to unduly delay the expenditure of amounts on charitable activities.” In such a situation, each of the two charities are “jointly and severally, or solidarily” liable for the penalty.

⁸ Section 163 of the Act imposes civil penalties on third parties. Subsection 163.2(1) provides that “culpable conduct” means “conduct, whether an act or a failure to act” that is (a) “tantamount to intentional conduct,” (b) “shows an indifference as to whether this Act is complied with” or (c) “shows a wilful, reckless or wanton disregard of the law.”

⁹ See details in section B.2 below regarding the procedures required in order to suspend this privilege.

2. Procedures to suspend tax-receipting privileges

Section 188.2 of the Act introduced by the September 2004 Amendments confers the power on the Minister of National Revenue (the “Minister”) to suspend tax-receipting privileges under certain circumstances.

Subsection 188.2(1) provides that once the Minister issues an assessment giving notice by registered mail of a penalty under any of the following three situations, then the registered charity would be suspended from issuing official donation receipts for a period of one year, seven days after the mailing of the said assessment by the Minister:

- a) subsection 188.1(2);
- b) paragraph 188.1(4)(b); or
- c) subsection 188.1(9) if the total penalties for a taxation year exceeds \$25,000 as explained above.

Subsection 188.2(2) goes on to provide that the Minister may also suspend a registered charity’s tax-receipting privilege under two additional situations:

- a) if the charity contravenes any of sections 230 to 231.5 of the Act, i.e. sections of the Act relating to administration and enforcement, such as the requirement to keep proper books and records; or
- b) if it may “reasonably be considered” that the registered charity has “acted in concert” with another charity in avoiding the effect of a suspension by accepting a gift or transfer of property on behalf of the suspended charity.

Paragraph 188.2(3)(a) provides that the issuance of the assessment notice by the Minister under subsection 188.2(1) or (2) would have the effect of deeming the registered charity in question not to be a qualified donee for purposes of the Act during the one year period commencing seven days after the mailing of the assessment by the Minister. In addition, paragraph 188.2(3)(b) provides that if the registered charity is offered a gift during the said one-year period, then the charity must inform the donor of the following before accepting the gift:

- a) the charity has received the said assessment notice from the Minister;
- b) no charitable deduction or credit may be claimed by the donor; and

- c) the gift made would not be a gift made to a qualified donee.

Subsection 188.2(4) provides that the registered charity in question may, after having filed a notice of objection to a suspension, file an application with the Tax Court of Canada for a postponement of that portion of the period of suspension that has not elapsed until the time determined by the Court. Subsection 188.2(5) provides that the Court may grant such an application only if it would be “just and equitable” to do so.

From a practical standpoint for donors, although registered charities whose tax-receipting privilege have been suspended have to advise donors of the same under paragraph 188.2(3)(b), it would be helpful to charities for CRA to publish on its website a list of all registered charities whose tax-receipting privilege has been suspended in order to avoid donors making donations to these entities.

3. Summary of intermediate taxes and penalties

The following chart was included in the 2004 Budget to provide specifics of the infraction in question, together with taxes and penalties that apply for both first infractions and repeat infractions. We have expanded the chart by including the relevant sections of the Act set out in the September 2004 Amendments.

Infraction	Tax or Penalty (Unless registration of the charity is revoked)			
	First infraction		Repeat infraction (Repeated acts or omissions will increase the probability of revocation)	
	Penalty	Proposed sections of the Act	Penalty	Proposed sections of the Act
Late filing of annual information return	\$500 penalty	188.1(6)	\$500 penalty	188.1(6)
Issuing of receipts with incomplete information	5% penalty on the eligible amount stated on the receipt	188.1(7) [also see amendments to sections 3501 and 3502 of the <i>Income Tax Act Regulations</i>]	10% penalty on the eligible amount stated on the receipt	188.1(8) [also see amendments to sections 3501 and 3502 of the <i>Income Tax Act Regulations</i>]

Infraction	Tax or Penalty (Unless registration of the charity is revoked)			
	First infraction		Repeat infraction (Repeated acts or omissions will increase the probability of revocation)	
	Penalty	Proposed sections of the Act	Penalty	Proposed sections of the Act
Failure to comply with certain verification and enforcement sections of the Income Tax Act (230 to 2315), e.g. keeping proper books and records	Suspension of tax-receipting privileges	188.2(2)	Suspension of tax-receipting privileges	188.2(2)
Charitable organization or public foundation carrying on an unrelated business	5% tax on gross unrelated business revenue earned in a taxation year	188.1(1)	100% tax on gross unrelated business revenue earned in a taxation year and suspension of tax-receipting privileges	188.1(2) and 118.2(1)
Private foundation carrying on any business	5% tax on gross business revenue earned in a taxation year	188.1(1)	100% tax on gross business revenue earned in a taxation year, and suspension of tax-receipting privileges	188.1(2) and 118.2(1)
Foundation acquires control of a corporation	5% tax on dividends paid to the charity by the corporation	188.1(2)(a)	100% tax on dividends paid to the charity by the corporation	188.1(3)(b)
Undue personal benefit provided by a charity to any person.	105% tax on the amount of undue benefit	188.1(4)(a) [undue benefit is defined in 188.1(5)]	110% tax on the amount of undue benefit and suspension of tax-receipting privileges	188.1(4)(b) and 188.2(1) [undue benefit is defined in 188.1(5)]
A gift that is restricted under subsections 149.1(2), (3) or (4) of the Act	105% tax on the amount of the gift	188.1(4)(a) [undue benefit is defined in 188.1(5)]	110% tax on the amount of the gift	188.1(4)(b) and 188.2(1) [undue benefit is defined in 188.1(5)]
Issuing receipts in a taxation year for eligible amounts that in total do not exceed \$20,000 if there is no gift or if the receipt contains false information	125% tax on the eligible amount stated on the receipt	188.1(9) and (10)	125% tax on the eligible amount stated on the receipt	188.1(9) and (10)
Issuing receipts in a taxation year where there is no gift or where the receipt contains false information	125% tax on the eligible amount stated on the receipt (Suspension of tax-receipting privileges if total penalty under subsection 188.1(9) exceeds \$25,000 in a taxation year.)	188.1(9), (10), and 188.2(1)	125% tax on the eligible amount stated on the receipt (Suspension of tax-receipting privileges if total penalty under subsection 188.1(9) exceeds \$25,000 in a taxation year.)	188.1(9), (10), and 188.2(1)
Delaying expenditure of amounts on charitable activities through the transfer of funds to another registered charity	The charities involved are jointly and severally, or solidarily, liable for 110% of the amounts so transferred	188.1(11)	The charities involved are jointly and severally, or solidarily, liable for 100% of the amounts so transferred	188.1(11)
Assisting another registered charity in avoiding the effect of a suspension of tax-receipting privileges by accepting gifts or transfer of property on behalf of the suspended charity	Suspension of tax-receipting privileges	188.2(2)	Suspension of tax-receipting privileges	188.2(2)

C. OTHER MATTERS RELATING TO PENALTIES

1. Reduction of penalties

The September 2004 Amendments provide that where a charity is required to pay taxes or penalties which total more than \$1,000 in a particular taxation year, the charity will be permitted to reduce the tax or penalty liability by certain amounts. Specifically, new subsection 189(6.3) applies to registered charities that the Minister assesses for penalties under section 188.1 for a taxation year in excess of \$1,000. The charity may reduce the liability by the value of property transferred to an eligible donee in the one-year period following the assessment date, exceeds the consideration given to the charity. New subsection 189(6.3) applies to notices issued by the Minister after the later of December 31, 2004 and 30 days after Royal Assent.¹⁰

2. Interest on penalties

Subsection 189(7) of the Act currently applies in respect of interest applicable to liabilities under Part V of the Act. This subsection is replaced with subsection 189(9) of the Act. New amended subsection 189(9) modifies subsection 161(11) for the purposes of liabilities under Part V. In this regard, interest on penalties under section 188.1 of the Act accrues only on the balance remaining one year after the liability was first assessed. Subsection 189(9) applies in respect of notices issued by the Minister after the later of December 31, 2004 and 30 days after Royal Assent.¹¹

3. Appeals

Appeals from decisions concerning refusal to grant registered charitable status or revocation of registered charitable status will need to continue to be made to the Federal Court of Appeal. However, appeals of taxes and penalties will be directed to the Tax Court of Canada. Specifically, subsection 189(8.1) clarifies that a taxpayer may not appeal to the Tax Court of Canada in respect of an issue that could be the subject of a notice of objection filed under new subsection 168(4) of the Act.¹² This

¹⁰ See *Charity Law Bulletin* No. 55 dated October 30, 2004 for details on these changes, including the definition of “eligible donee.”

¹¹ See *Charity Law Bulletin* No. 55 dated October 30, 2004 for details on these changes.

¹² See *Charity Law Bulletin* No. 55 dated October 30, 2004 and *Charity Law Bulletin* No. 56 dated October 31, 2004 for details on these changes.

amendment applies in respect of notices issued by the Minister after the later of December 31, 2004 and 30 days after Royal Assent.

D. CONCLUSION

The above is a summary of intermediate taxes and penalties introduced by the 2004 Budget as implemented by the September 2004 Amendments. This is a welcome change that provides a more appropriate recourse for unintended or incidental breaches of the Act by registered charities, as opposed to the only recourse previously available being the revocation of their charitable status.