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GUIDELINES FOR APPLYING THE NEW INTERMEDIATE SANCTIONS FOR CHARITIES

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A. INTRODUCTION

On April 10, 2007, the Canada Revenue Agency ("CRA") released a new policy document, "Guidelines for Applying the New Sanctions" (the "Guidelines").[1] This document sets out CRA's approach to the application of the new intermediate sanctions resulting from amendments to the *Income Tax Act* (the "ITA")[2] enacted by Bill C-33, *A second Act to implement certain provisions of the budget tabled in Parliament on March 23, 2004*, which received Royal Assent on May 13, 2005.[3] CRA monitors registered charities' compliance with the ITA by way of an audit process and it is during this audit process that the application of intermediate sanctions would most likely arise. The audit process includes the examination of a charity's financial affairs, the review of its activities to determine whether it is operating in accordance with its charitable purposes, and the evaluation of any evidence which might indicate whether or not it is satisfying its legal obligations under the ITA. It is important for charities to understand the audit process and interim sanctions in order to understand the context of the Guidelines.

[1] Available online at: http://www.cra-arc.gc.ca/tax/charities/policy/newsanctions-e.html.
[2] R.S.C. 1985, c. 1 (5th Supp.).
[3] See Karen J. Cooper, "Changes to Sanctions, Penalties and Appeals Process for Charities" in *Charity Law Bulletin* No. 82 (January 11, 2006) online: http://www.carters.ca/pub/bulletin/charity/index.html.

B. THE NEW SANCTIONS

The ITA now includes two new kinds of penalties: (1) financial penalties; and (2) a one-year suspension of the charity's ability to issue official donation receipts. Usually a financial penalty is invoked first. Repeated violations may lead to higher financial penalties and sometimes the suspension of the right to issue official donation receipts. Initially, this right is normally suspended for the duration of one year only. A charity which has a financial penalty greater than $1000 may choose to pay the amount to a charity which is an eligible donee, rather than paying it to the Receiver General. Eligible donees are essentially arm's length charities which are not under any interim sanction by CRA.[4]

If a sanction is imposed on a charity, a variety of information about the charity will be made public on the Charities Directorate's website, including:

- The charity's name;
- The sanction applied, including the dollar amount (if applicable);
- The date on which the sanction became effective;
- The reason for the penalty; and
- The results of the appeal (if applicable).

In order to avoid the imposition of more rigorous sanctions, there are a number of obligations that a charity must fulfill while its charitable status is under suspension, including informing any individuals and organizations planning to make a donation to the charity of its suspended status. The charity is permitted to receive donations but it cannot issue official donation receipts. If it does so, CRA intends to revoke the organization's charitable status. Where one charity is making a gift to another suspended charity and the donating charity is aware of the charity's suspended status and accepts an official donation receipt, CRA intends to suspend the donating charity's charitable status.[5]

C. TYPES OF NON-COMPLIANCE SUBJECT TO SANCTION

1. Business Activities

A charitable organization or a public foundation which carries on an unrelated business, or a private foundation which carries on any kind of business, is subject to penalties. CRA has a Policy Statement on what constitutes a related business. It outlines the Charities Directorate's policy "for determining

[4] *Supra* note 2 at subsection 188(1.3).
[5] Subsection 188.2(3) of the ITA deems the suspended charity not to be a qualified donee.

whether an applicant organization or an existing registered charity is carrying on an acceptable business (a "related" one) or an unacceptable business (an "unrelated" one)."[6]

Normally, CRA will provide a charity with the opportunity to cease from operating the business or unrelated business. Usually this opportunity is provided by way of a compliance agreement. If the charity initially fails to divest itself of the business or unrelated business, the penalty is 5% of the gross revenue from the business. For a subsequent infraction, the penalty is 100% of the gross revenue, as well as a one-year suspension.

2. Control of a Corporation (foundations only)

A penalty applies if a public foundation or a private foundation acquires control over a corporation, unless the foundation received the controlling shares as a donation. CRA's Summary Policy on this subject contains further information.[7] Unless the infraction is considered serious, CRA will normally address this issue by way of a compliance agreement. The penalty for a first-time infraction is 5% of the dividends which the corporation pays to the charity in a year. For a subsequent infraction, the penalty is 100% of the dividends.

3. Gifts to Non-Qualified Donees

A penalty applies in the situation where a charity makes a gift to a person (*i.e.*, under the ITA a "person" is an individual, company or a partnership) who is not a qualified donee. Qualified donees are those entities which are permitted to issue official donation receipts in exchange for gifts, which includes, among others, registered charities, registered Canadian amateur athletic associations, municipalities, and the United Nations and its agencies. Again, unless the infraction is considered serious, CRA's preference is to address the problem by way of a compliance agreement. The penalty for a first infraction is 105% of the amount donated to a non-qualified donee. For a repeat infraction, the penalty is 110% of the amount.

[6] Canada Revenue Agency, Policy Statement CPS-019, "What is a Related Business?", Effective Date: March 31, 2003, online: http://www.cra-arc.gc.ca/tax/charities/policy/cps/cps-019-e.html.
[7] Canada Revenue Agency, Summary Policy CSP – C28, "Control of Corporations - Sanctions", November 3, 2005, online: http://www.cra-arc.gc.ca/tax/charities/policy/csp/csp-c28-e.html.

4. Undue Benefit

A penalty applies to a charity (or to a third party acting with the charity's knowledge or on its instructions) which confers an "undue benefit" on:

- A member of the charity or a member of its board of directors;
- A person who has given more than 50% of the charity's capital;
- A person who is not at arm's length to another person:
  - who is a member of the charity or its board of directors; or
  - who has given more than 50% of the charity's capital; or
- A person who is not at arm's length to the charity.

In order to avoid being considered as having conferred an undue benefit, a charity can make a reasonable payment for the services or property received from any of these persons. As in the previous examples, unless the violation is serious, CRA will normally enter into a compliance agreement with the charity. The penalty for a first infraction is 105% of the benefit. For a repeat infraction, the penalty is 110% of the amount, as well as a one-year suspension.

5. False Information on Official Donation Receipts

A penalty applies if an officer, employee, official or agent of the charity issues an official donation receipt containing false information. The penalty could also apply to other people who:

- Counterfeit the official donation receipts of a legitimate charity; or
- Issue false receipts on behalf of an organization which is ineligible to issue them.

As CRA considers false information a serious infraction, more severe sanctions are imposed, including proceeding directly to revocation. The Guidelines indicate that "for any infraction, the penalty is 125% of the eligible amount of the gift as it appears on any false receipt, plus a year's suspension if the total of all such penalties exceeds $25,000. If by issuing false receipts, the person is also subject to a penalty under section 163.2 of the ITA (the section that provides for penalties for those who help or encourage others to make false claims on their tax returns, usually as part of a tax-shelter promotion),[8] the person is subject to whichever penalty is larger."

[8] For further information on section 163.2 of the ITA, see CRA's Information Circular 01-1 "Third-Party Civil Penalties", online: http://www.cra-arc.gc.ca/E/pub/tp/ic01-1/README.html.

6. Incorrect Information on Official Donation Receipts

A penalty applies to a charity which issues an official donation receipt which contains incorrect information as distinguished from false information. Incorrect information includes omitted information that should be contained on the receipt, such as CRA's website address: www.cra.gc.ca/charities. Samples of official donation receipts are included on CRA's website.[9]

As in most of the examples, unless the infraction is serious, CRA will enter into a compliance agreement with the charity. The penalty for a first infraction is 5% of the eligible amount of the gift as it appears on the incorrect receipt. For a repeat infraction, the penalty is 10% of the amount.

7. Inadequate Books and Records

A penalty applies to a charity which does not maintain adequate books and records, as well as to a charity which does not permit an auditor the right to review the books and records, or permission to copy them. Further information about books and records can be found on CRA's website.[10]

Compliance agreements are generally invoked first. However, sanctions will be imposed on more serious infractions, possibly even revocation of charitable registration. The penalty for an infraction involving inadequate books and records is a one-year suspension.

8. Inter-charity Gifting to Delay Expenditures

A charity is subject to a penalty if it exchanges gifts in order to delay expenditures required to meet its disbursement quota. CRA provides the following example: "Two charities have a disbursement quota of $10,000. Charity A writes a $10,000 cheque to Charity B, and Charity B writes an equivalent cheque to Charity A. Both claim to have met their disbursement quota on the basis of a $10,000 gift to a qualified donee, but in reality neither charity has made any expenditure."

CRA considers this a serious infraction, and as such it would proceed directly to applying a penalty. Both charities are subject to a penalty equivalent to 100% of the amount that was exchanged.

[9] Canada Revenue Agency, "Samples – Official Donation Receipts", online: http://www.cra-arc.gc.ca/tax/charities/pubs/receipts-e.html.
[10] Canada Revenue Agency, "Registered Charities and the *Income Tax Act*", online: http://www.cra-arc.gc.ca/E/pub/tg/rc4108/ and *Charities Registered Newsletter* No. 26, online: http://www.cra-arc.gc.ca/E/pub/tg/charitiesnews-26/README.html.

Sometimes the penalty is split between the two charities, but in some cases CRA will apply the entire penalty against either charity.

9. Not Filing the Annual Return

A penalty applies to a charity which does not file its annual return on time. The ITA provides for a $500 penalty for this infraction. CRA currently only applies this penalty to charities which:

- have had their registration revoked for not filing an annual return; and
- apply for re-registration of charitable status.

Charities which lose their charitable registration must proceed quickly to avoid the revocation tax imposed under the ITA.[11] Within twelve months of the receipt of a notice from CRA that it intends to revoke a charity's registered status, the charity must:

- rectify its filing deficiency;
- pay any outstanding penalties, including the $500 non-filing penalty indicated above, as well as taxes and interest pursuant to the ITA and the *Excise Tax Act*;[12] and
- obtain re-registration.

10. Failure to Divest of Excess Business Holdings (private foundations only)

In the Federal Budget released on March 19, 2007, the federal government upheld its commitment from the 2006 Budget to remove the capital gains tax on publicly listed securities donated to private foundations, effective immediately, but also imposed a new excess business holdings regime for private foundations. The proposed regime will require a private foundation to continuously monitor its holdings and acquisitions of both publicly listed and private corporation shares. Depending upon the amount of its interest, and that of persons not dealing at arm's length with the foundation, in a particular class of shares of a company, a private foundation will be required to divest itself of some of the shares. A penalty will apply in respect of a foundation's excess business holdings that have not been divested as required. The proposed penalty is 5 percent of the value of excess holdings, increasing to 10 percent if a second infraction occurs within 5 years. Further, if a foundation is subject to such a penalty and has failed to provide information as required in respect of the particular shares, the penalty will be doubled.

[11] For further information about re-registration and the revocation tax, see "Completing the Tax Return Where Registration of a Charity is Revoked", online: http://www.cra-arc.gc.ca/E/pub/tg/rc4424/README.html.
[12] R.S.C. 1985, c. E-15.

D. CRA'S GENERAL APPROACH

Until recently, the end product of an audit was either revocation of the charity's registered status or the issuance of an undertaking letter requiring the charity to carry out certain corrective actions to become compliant. Under the new regime, CRA will have four tools to ensure that registered charities comply with their obligations:

- Education (either general publications or a letter specifically addressed to a charity explaining its obligations under the ITA);
- Compliance agreement (similar to the former undertaking letter);
- Imposition of an interim sanction or penalty (a financial penalty or the suspension of the charity's status as a qualified donee and the capacity to issue official donation receipts; and
- Revocation of registered charitable status.

Most cases of non-compliance related to issues which can be sanctioned under the new legislation will be addressed through the use of a compliance agreement. This agreement will outline the non-compliance issues and remedial actions which the charity has agreed to undertake in order to comply with its obligations under the ITA. It will also include a paragraph which advises the charity that a penalty and/or suspension could apply if the agreement is not upheld. As opposed to the current undertaking letter, the Compliance Agreement will be a formal document signed and dated by both parties and will include a timeframe for the charity to make the necessary changes as outlined in the agreement. The cover letter that will accompany the agreement may also address other minor non-compliance issues that may have been identified but that do not form part of the agreement. As a general rule, the Charities Directorate intends to start with educational methods to obtain compliance, and then move progressively through compliance agreements, sanctions, and the ultimate sanction of revocation, if necessary.

However, in cases of serious non-compliance, CRA intends to move directly to the imposition of a sanction or revocation. The Guidelines identify examples of serious non-compliance from CRA's perspective, including:

- Where non-compliance reaches a particular upper limit, *e.g.*, the percentage of funds spent on non-charitable activities is too high;
- Where non-compliance involves breaches of the *Criminal Code*[13] or other quasi-criminal statutes;
- Where non-compliance involves violations of central provisions of the ITA; or

[13] R.S.C. 1985, c. C-46.

- Where charity is not acting in accordance with the terms of a compliance agreement.

The Guidelines also indicate a number of examples of "aggravated non-compliance" which would likely lead directly to revocation:

- The charity has a history of serious non-compliance and its current lack of compliance is considered both serious and deliberate;
- The non-compliance is having a negative impact on others, such as beneficiaries and donors, and the charity is either unable or unwilling to reverse that adverse impact; or
- The charity is either unable or unwilling to bring itself into compliance.

The Guidelines provide two further examples of action or inaction on the part of charities that will probably result in the revocation of charitable status:

- Where, after a maximum of one reminder, a charity fails to file its annual return; and
- Where there is no appropriate sanction for a serious breach, *e.g.*, engaging in non-charitable activities.

The Charities Directorate acknowledges that exceptional situations beyond a charity's control do occur, in which case, a less severe sanction would likely be imposed.

E. PROCEDURES

CRA's auditors, sometimes in conjunction with the Charities Directorate staff, determine whether to encourage a charity's compliance by way of education or through a compliance agreement. If a subsequent examination of an organization that was dealt with by education letter or compliance agreement reveals that the charity has not fulfilled its obligations under the agreement or the audit findings are sufficiently serious, CRA may apply the relevant penalty or sanction. An auditor's supervisor also plays a key role in evaluating which intermediate sanction to use. Once the charity has been informed of the sanction, it has a 30-day window in which to propose why it should not be subject to the proposed sanction. The Charities Directorate will then make a decision with respect to whether to impose a sanction and then it notifies the charity accordingly. If a sanction is imposed, the charity then has a 90-day window in which to object to the sanction by filing a notice of objection with the CRA's Appeals Branch. Should a suspension be invoked, the charity may make an application to the Tax Court of Canada to postpone the application of the suspension. As indicated above, there may be situations of what CRA terms "aggravated non-compliance" on the part of

charities, in which case there would likely be a direct move toward revocation. In such a situation, a charity would have 30 days in which to file a stay with the Federal Court of Appeal.

F. CONCLUSION

CRA now has a variety of ways in which to encourage registered charities to comply with the legal requirements pursuant to the ITA. These methods include education, compliance agreements, interim sanctions and revocation. According to the Guidelines, education and compliance agreements are CRA's preferred means of working with registered charities. However, there are charities which require more serious measures to bring them back into line and the Guidelines indicate under what circumstances that CRA intends to employ such measures.

The new intermediate sanctions and CRA's new approach to ensuring compliance are important changes for charities, providing more appropriate recourse for unintended or incidental breaches. However, the regulation of charities is ever-increasing in scope and complexity, and will require careful review by charities and their advisors.

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