
FOREIGN ACTIVITIES: HOW TO GET READY FOR A CRA AUDIT

*By Jacqueline M. Demczur**

A. OVERVIEW

Charities that carry out activities abroad must ensure that they adhere to CRA's requirements for charities engaged in foreign activities. Failure to adhere to those requirements may lead to dire consequences such as the revocation of the charity's status as a registered charity accompanied by the directors and officers of the corporation becoming "ineligible persons." This bulletin reviews CRA's requirements on charities engaged in foreign activities, as well as discusses the pro-active steps that such charities may take in order to prepare for a CRA audit.

B. CRA'S BASIC REQUIREMENTS WHEN CARRYING ON FOREIGN ACTIVITIES

The applicable requirements imposed on charities carrying on foreign activities are outlined in CRA Guidance CG-002, *Canadian Registered Charities Carrying Out Activities Outside Canada* ("Guidance"), available online at <http://www.cra-arc.gc.ca/chrts-gvng/chrts/plcy/cgd/tsd-cnd-eng.html>. According to the Guidance, a Canadian registered charity may only use its charitable resources in the following two ways: (a) to make gifts to qualified donees, as defined under the *Income Tax Act*¹ (ITA), which includes other

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¹ R.S.C., 1985, c. 1 (5th Supp.).

Canadian registered charities, prescribed universities outside Canada, the United Nations, etc.; and (b) to carry on its own programs and activities.²

In “carrying on its own activities”, it is meant that all of the activities of a Canadian registered charity are directly under its own control and supervision and that it can account for any and all funds expended on the said activities. In order to be considered to be carrying on its own activities, a Canadian registered charity must be *actively* involved in all programs and projects carried out utilizing its charitable funds, with the said programs and projects intended to achieve its own charitable purposes. This is most usually done by the Canadian charity using its charitable resources to directly fund its *own* employees and volunteers in carrying out the programs and activities in question. It is not permissible for a Canadian registered charity to simply give or transfer its monies or other charitable resources to another organization which is not a qualified donee under the ITA.³

That said, CRA does permit a Canadian registered charity to carry out its programs and activities by transferring charitable resources to, and working with, third party intermediaries that are not qualified donees under the ITA, (i.e. organizations or individuals located either inside or outside of Canada). However, when working through an intermediary, a charity must direct and control the use of its resources.⁴

The question then becomes how a Canadian registered charity evidences its direction and control over its charitable resources, particularly when it is involved in working through an intermediary. The starting point for evidencing direction and control is for the Canadian charity to ensure that it has prepared and entered into proper written agreements with all of its intermediaries setting out the terms of the “structured arrangement” between them. Although it is not a legal requirement to have a written agreement, CRA recommends the creation of a written agreement and implementation of its terms and provisions.⁵ However, where the Canadian charity spends \$1,000 or less on a one-time activity, other forms of communication may be used to demonstrate direction and control over the use of resources of intermediaries.⁶

² Canada Revenue Agency, Guidance CG-002, “Canadian Registered Charities Carrying Out Activities Outside Canada” (8 July 2010) at para. 5.

³ *Ibid.*, para. 1.1.

⁴ *Ibid.*, para. 6.

⁵ *Ibid.*, para. 7.1.

⁶ *Ibid.*, para. 7.2.

As well, other measures recommended by CRA for maintaining direction and control of a charity's resources include:

- 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;
- Segregate funds, as well as books and records, for agency relationships; and
- Make periodic transfers of resources, based on demonstrated performance.⁷

In addition to these measures, the Canadian charity's board of directors must exercise initial oversight in carefully reviewing and determining which of its charitable programs and activities (i.e. those which fulfill its charitable objects approved by CRA) it wishes to carry out through intermediaries and which intermediaries are the most appropriate ones to utilize in carrying out the said programs and activities.

Thereafter, the Canadian charity, with the ultimate responsibility being in the hands of its board of directors, must ensure that it is exercising ongoing supervision of the programs and activities being carried out on its behalf by intermediaries, and that all monies spent by the Canadian charity on these programs and activities (i.e. being transferred to the intermediaries in question) are properly utilized and accounted for. In this regard, the board of directors of the Canadian charity cannot simply "rubber stamp" foreign activities proposals that are submitted to them by intermediaries and then transfer charitable resources to such intermediaries. Instead, charities must have proper written agreements in place in accordance with CRA requirements and, thereafter, take steps to ensure that the transferred charitable resources are, in fact, used for the intended programs and activities. This may require obtaining evidence of the same from the intermediaries. Failing to supervise the programs and services and to ensure the charitable resources are spent properly can pose significant risks to the charity's ongoing charitable registration.

C. TYPES OF INTERMEDIARIES

There are four common types of intermediaries that Canadian charities can utilize to carry on its programs and activities outside of Canada. The applicability, but more importantly the suitability, of these intermediary options will depend on a charity's particular circumstances and the nature of the foreign

⁷ *Ibid.*, para. 7.1.

activities to be engaged in through its intermediary(ies). A brief description of each type of intermediary is provided below.

The first type of intermediary is an agent that agrees to carry out specific activities on the Canadian charity's behalf. An agent is used when the Canadian charity is unable to send its own staff into the field to carry out its activities.⁸ While agents can be helpful in achieving a charity's objectives, CRA warns charities to consider how they structure their agency arrangements because the existence of an agency relationship could expose them to vicarious liability for the acts of their agents. Vicarious liability can expose a Canadian charity to significant liability, both civil and criminal (e.g. anti-terrorism legislation). Even where a formal agency agreement is not in place, a court may still assign liability to the Canadian charity if the circumstances indicate that an implied agency relationship existed.⁹

Canadian charities considering the use of an agent should note that some insurers may be concerned about the vicarious liability risks that are associated with agency relationships. Unless these risks are disclosed to the insurer, they may not be covered by insurance policies. As such, a Canadian charity should advise its insurer in writing of the nature and extent of its agency relationships and obtain a written response from the insurer to avoid any surprises.

A second type of intermediary is a joint venture participant, which is an organization that works with a Canadian charity to carry out a charitable activity. Pursuant to a joint venture agreement, the Canadian charity and the joint venture participant(s) combine their resources to accomplish their mutually agreed upon goals. The Canadian charity does not rely entirely on the joint venture participant(s) to carry out activities for the charity. A charity can work with non-qualified donees as long as the charity is exercising control over the activities proportionate to the resources it is providing and it can demonstrate this fact.¹⁰

A third type of intermediary is a cooperative participant, which is an organization that works side-by-side with the Canadian charity. A cooperative participant is only responsible for certain parts of a project that it is working on with the charity, and therefore does not share responsibility with the charity.¹¹

⁸ *Ibid.*, at para. 6.2.

⁹ *Ibid.*, para. 6.2.

¹⁰ *Ibid.*, at para. 6.3

¹¹ *Ibid.*, at para. 6.4.

Finally, the fourth type of intermediary is a contractor for services, which is the most commonly used these days. A contractor for services is an organization or individual that is hired by the Canadian charity to provide goods and/or services. Contractors can be organizations or individuals and do not need to be either qualified donees under the ITA or recognized charities in their own countries. Direction and control is typically exercised by the Canadian charity through its agreement with the contractor.¹² The registered charity must give specific instructions to its contractors.

The contractor for services is the most commonly used intermediary because there are a number of advantages to the Canadian charity through the use of this type of intermediary. The main advantage is reduced liability exposure for the Canadian charity for the actions undertaken by the intermediary, as compared to potential vicarious liability exposure that arises from the principal-agent arrangement more commonly utilized in the past.

Other advantages in utilizing a contractor for services include the lack of any requirements to segregate funds or to reflect assets already transferred to the agent in the financial statements of the charity. As well, once assets have been transferred to a third party contractor under a contract of service, such assets are treated as having been expended for the purpose of the Canadian charity's 3.5% disbursement quota. For disbursement quota purposes, the time at which monies are paid by a Canadian charity to a contractor under a contract of services would be the time of the expenditure and not when the contractor fulfills the terms of the contract. Another advantage is that the absence of vicarious liability may make a contract of service more attractive to an insurer as compared to an agency relationship.

D. GETTING READY FOR A FUTURE CRA AUDIT

In general, where a charity is engaged in foreign activities and uses intermediaries to carry out such activities, it is more likely to be audited by CRA. Given this reality, it is important that a charity take steps on a contemporaneous basis to ensure that it is carrying out foreign activities through intermediaries in strict compliance with CRA requirements, including ensuring that proper books and records are kept in relation to all such activities. Such practices will serve the charity well if and when it is audited by CRA.

¹² *Ibid.*, para 6.5.

Failing such contemporaneous best practices regarding proper books and records being in place by the charity in relation to its foreign activities, it is important that the charity take steps to prepare for any pending CRA audit. In this regard, it is generally recommended that charities consider carrying out a “pre-audit” in order to determine if it is in compliance with CRA requirements.

The purpose of such a pre-audit compliance review is to:

- Identify all foreign activities/projects of the charity (past, present and future contemplated);
- Review whether there has been compliance with CRA requirements for each activity/project;
- Compile all key documents for each activity/project; and/or
- Engage in remedial steps, as necessary.

Although CRA can audit any fiscal year of a Canadian charity, it generally will focus on the last five years of the charity’s operations. Accordingly, these years should be the focus of the pre-audit, starting with the earliest financial year and working forward. It is highly recommended that the charity’s own legal counsel be involved in the pre-audit in order to establish solicitor-client privilege and an accountant be retained as well.

The first step in a pre-audit is the identification of any foreign activities or projects that the Canadian charity is engaged in. This step involves a review of the charity’s annual general ledger for the last five years. When reviewing the general ledger, the charity will need to identify every single transaction which involved the transfer of charitable property (e.g. cash or gifts in kind) to a non-qualified donee. For every transaction, the charity will need to identify the following:

- Who the non-qualified donee recipient of the charity’s property is;
- The nature of the relationship with the non-qualified donee, e.g. agency, contract for services;
- Whether the non-qualified donee has utilized another organization to do the project in question, e.g. sub-agent or sub-contractor;
- The nature of activity/project for which charitable property was used;
- Whether this was a one-time transaction or one of many involving the non-qualified donee;
- The nature of the charitable property transferred; and
- What, if any, written documentation regarding the transfer(s) is immediately accessible.

As part of this process, it will be necessary to prepare a summary of the transactions of potential concern, group them together as necessary, and preliminarily identify issues to be reviewed further with legal counsel (and the accountant).

The second step of the pre-audit is to determine if the Canadian charity's foreign activities have been conducted in compliance with CRA's requirements. This step involves gathering all supporting documentation that demonstrates "direction and control" by the charity over its foreign activities. A convenient and efficient way of organizing the documentation is to create separate project folders for each foreign activity or project. A compliance checklist that outlines all of the steps/documentation that is required by CRA should be attached to the inside cover of each project folder. Each project folder should be numbered and then cross-referenced to the applicable transactions on the general ledger. This type of cross-referencing system will facilitate easy access to the applicable project folder in the event that an actual CRA audit occurs and questions are raised about a particular project or transaction listed on the general ledger.

The compliance checklist for each project folder should generally include the following:

- The date that the pre-audit was completed for the project;
- The assigned project program number;
- The project's name;
- Identification of the project type (eg. if it falls within one of the charity's main project areas);
- The name of the non-qualified donee (eg. contractor, agent, etc.);
- The name of any additional third parties involved in the project (eg. sub-contractor, sub-agents), if applicable;
- The total funds transferred, together with interim fund transfers, if applicable, including dollar amounts and dates; and
- Required Documents – Indicate if the following required documents have been located, date completed and if any additional steps need to be taken:
 - Original project proposal;
 - Board approval of project (include copy of applicable board minutes);
 - Written agreement;

- Project designations(s) for contractor/agent (for initial and any interim fund transfers);
- Wire transfer and letter;
- Any sub-agreement with sub-contractor/sub-agent, if applicable;
- Sub-project designation(s) (for initial and any interim fund transfers);
- Interim project reports and, if applicable, sub-project reports;
- Final project reports and, if applicable, sub-project reports;
- Board acceptance of all project reports (include copy of board minutes);
- Photographs, brochures and other evidence that the project took place;
- Any correspondence between the charity and contractor showing charity's supervision and involvement in the project;
- On-site reports by charity's directors, staff and/or volunteers;
- Receipts/vouchers or audit letter in lieu of receipts/vouchers; and
- Additional notes, as required.

The charity must complete the checklist for each project folder, and in doing so, identify which steps have (or have not) been taken by the charity and which documentation is (or is not) readily available.

The third step in the pre-audit is to compile all key documents for each activity or project. Having identified the outstanding documentation that needs to be in place for a project, such documentation should be located and inserted into the applicable project folder. Once this process is complete, the charity should meet with its legal counsel to review the current state of the project folders and the next steps that need to be taken by the charity. It may be necessary to contact the intermediary and explain the documents that the charity is looking to obtain and following up to ensure that said documents are provided to the charity.

The fourth step is to take remedial action, if necessary. The exercise of locating documentation in the previous step may have resulted in the discovery that certain required documentation was never prepared and must now be created. Other remedial action may be necessary, depending on the charity's particular circumstances. Whatever the case, the charity should consult legal counsel prior to preparing remedial documents. Possible remedial action could include the following:

- Preparation of any missing reports from contractors and/or subcontractors, or preparation of more fulsome reports if initial ones are unsatisfactory;
- Translation of reports, if not done to date, into English and/or French;
- Obtaining any supporting documents in relation to the project, e.g. photographs, news articles, onsite visit reports by charity representatives, project related correspondence to or from the charity, etc.; and
- Obtaining receipts/vouchers or an audit report in lieu thereof.

As a result of carrying out a pre-audit, there are other related issues that the charity may become aware of and take steps to address before engaging in any further foreign activities through intermediaries. For example, the charity may wish to create an instruction manual for use in any future foreign activities. Alternatively, changes to the written agreement and the type of intermediary used (e.g. possibly switching from an agency agreement to a contract for service) may be considered by the charity. Further, in order to reduce the size of compliance requirements, the charity may wish to streamline the number of intermediaries that it charity works with in carrying out foreign activities. As well, the charity may wish to review whether its charitable work could be done through another Canadian registered charity, thereby eliminating or reducing its need to meet CRA compliance requirements related to foreign activities.

E. CONCLUSION

Canadian charities that engage in foreign activities should conduct a pre-audit in order to gauge their compliance with the CRA's requirements. This proactive step will flag any requirements that have not been met in the past and will allow charities to remediate these issues prior to an actual CRA audit. This process will also facilitate charities putting proper compliance measures in place now in order to properly carry out foreign activities through intermediaries in the future.