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CBA/OBA 2007 NATIONAL CHARITY LAW SYMPOSIUM

**TAX TIME FOR THE TERRIFIED**

**Toronto – May 10, 2007**

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**Cross Border Issues Under the Canada-U.S.  
Tax Treaty: U.S. Charities Operating in  
Canada**

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**By Theresa L.M. Man, B. Sc., M.Mus., LL.B.**

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**INTRODUCTION**

- The operations of many charities have become increasingly international in scope
- U.S. charities to have operations in Canada, *vice versa* for Canadian charities
- Application of *Canada-United States Income Tax Convention (1980)* and the *Income Tax Act (Canada)* to U.S. charities operating in Canada
- “U.S. charities” – means tax-exempt entities in the U.S. that qualify under section 501(c)(3) of the U.S. *Internal Revenue Code*

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**OVERVIEW**

- Article XXI(1) – reciprocal recognition of tax exemption status for religious, scientific, literary, educational or charitable organizations so that certain income earned by U.S. charities in Canada is exempt from Canadian tax
- Article XXI(6) –deduction of charitable donations made by Canadian donors to U.S. charities
- Other Possible Exemptions

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**RESIDENCY REQUIREMENT**

- In order for a U.S. charity to qualify for the benefits offered by Article XXI of the Treaty, the U.S. charity must be a “resident of” the U.S.
- Article IV(1) of the Treaty defines “resident of a contracting state” to mean any person who, under the laws of that state, is “liable to tax”
- Article IV is understood to include ... a not-for-profit organization that was constituted in that state and is, by reason of its nature, generally exempt from income taxation in that state

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- Two requirements:
  - Liable to tax in the U.S.
  - Constituted in the U.S.
- 1. Liable to tax in the U.S.
  - To be a resident of a contracting state, a person must be “liable to tax” in that state
  - It has been the long-standing position of CRA that, to be considered “liable to tax” for the purposes of the residence article of Canada’s tax treaties, a person must be subject to the most comprehensive form of taxation as exists in the relevant country

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- For Canada, this generally means full tax liability on worldwide income
- Tax professionals have suggested that this rationale could adversely affect charities and pensions which are not subject to tax in the contracting state
- CRA reviewed its position regarding the level of taxation a jurisdiction must levy on a person’s income before that person would be considered “liable to tax” under a tax treaty

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- CRA issued *Income Tax – Technical News 35* on February 26, 2007 to clarify the residency requirement under Canada’s tax treaties
  - CRA confirmed its long standing position,
  - There may be situations where a person’s worldwide income is subject to a contracting state’s full taxing jurisdiction but that state’s domestic law does not levy tax on a person’s taxable income or taxes it at low rates
  - The determination of residency for the purposes of a tax treaty is a question of fact

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2. Constituted in the U.S.

- In order for a U.S. charity to be recognized as a resident of the U.S., it must be “constituted” in the U.S.
- The 1995 technical explanation to the Treaty indicates that “not-for-profit organizations” in Article XXI(6) are organizations such as those listed in section 501(c) of the Code
- Since entities organized outside of the U.S. are permitted to apply for tax-exempt status under section 501(c)(3) of the Code, such exemption does not necessarily imply that the entity is resident in the U.S.

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**ARTICLE XXI(6) RECEIPT OF CHARITABLE DONATIONS FROM CANADIAN DONORS**

- The Treaty and the Act provide U.S. charities with the ability to receive donations from Canadian donors and issue donation receipts with which the donors may claim tax relief within certain limits
  1. Canadian donors who have U.S.-source income
  2. Other provisions under the Act
- 1. Canadian donors who have U.S.-source income
  - In general, under Article XXI(6) of the Treaty, where a U.S. charity receives a donation from a Canadian donor, the Canadian donor may claim a charitable credit or deduction

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- In order to take the benefit under Article XXI(6), the U.S. charity must meet the following criteria:
  - The donation must be a “gift”
  - The donation credit is only limited to the Canadian donor’s U.S.-source income
  - The U.S. charity must be resident in the U.S.
  - The U.S. charity must generally be exempt from U.S. tax, and it could qualify in Canada as a registered charity if it were a resident in Canada and created or established in Canada

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a) Transfer of gifts

- Article XXI(6) applies to “gifts” made to U.S. charities
- “Gift” is not defined in the Treaty or in the Act
  - To be defined in accordance with Canadian law
- Recent proposed amendments to the Act
  - “Split-receipting”
  - Amendment first proposed in December 2002, revised each year until most recently proposed in November 2006 (Bill C-33, first reading on November 22, 2006)

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b) Limit of donation

- The income tax relief available pursuant to Article XXI(6) is only applicable to the Canadian donor’s U.S.-source income up to the usual limits for charitable donations under the Act
- However, a Canadian donor’s tax will not be restricted to the donor’s U.S.-source income if the recipient U.S. charity is a U.S. college or university at which the donor, or a member of the donor's family, is or was enrolled

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- This would include donations made by students, alumni and their family members
- In this case, the universities do not need to be prescribed pursuant to Regulation 3503 and listed in Schedule VIII to the Act
- CRA requires the Canadian donor to obtain a receipt from the qualified U.S. charity - in spite of what is required under the Internal Revenue Service regulations for U.S. charities that acknowledgment letters or receipts may not need to be sent to donors

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c) Donor of gifts

- There may be an issue of whether Article XXI(6) applies only to gifts made by Canadian donors, or whether this provision would also apply to the transfer of gifts by Canadian registered charities
- IRS takes the position that U.S. charities may rely on Article XXI(5) of the Treaty in transferring contributions to Canadian registered charities
- CRA does not accept that Article XXI(6) would apply to gifts by Canadian registered charities to U.S. charities

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d) Charities resident in the U.S.

- Article XXI(6) of the Treaty requires that the U.S. charity must be resident in the U.S.

e) U.S. charities that could qualify in Canada as a registered charity

- CRA indicates that they accept any organization that qualifies under section 501(c)(3) of the Code will meet this test for purposes of Article XXI(6)
- But only religious, charitable, scientific, literary or educational charities would qualify for purposes of Article XXI(1)

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**f) Recognition procedure under the Treaty**

- Letter between the U.S. and Canada dated September 26, 1980
  - Competent authority of each contracting state would review the procedures and requirements for an organization of the other contracting state
  - In order to establish as a religious, scientific, literary, educational or charitable organization entitled to exemption under Article XXI(1) of the Treaty, or
  - In order to establish as an eligible recipient of charitable gifts or contributions referred to in Articles XXI(5) or XXI(6) of the Treaty

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- In 1999, IRS issued Notice 99-47 “Guidance Relating to Article XXI of the United States-Canada Income Tax Treaty”
  - It indicates that a mutual agreement has been entered into between Canada and the U.S. to implement the understanding confirmed in the Letter
  - Recognized religious, scientific, literary, educational or charitable organizations that are organized under the law of either the U.S. or Canada will automatically receive recognition or exemption without application in the other country

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- From CRA’s perspective:
  - Such an automatic recognition procedure is only available for U.S. charities seeking Treaty benefits under Article XXI(6) of the Treaty but not under Article XXI(1)
  - In order to seek benefit under Article XXI(1) of the Treaty, U.S. charities are required to submit an application to CRA’s International Tax Services Office
- By contrast, Canadian charities wishing to seek benefits under both Articles XXI(1) and XXI(5) of the Treaty in the U.S. can automatically be recognized in the U.S.

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**2. Other provisions under the Act**

- Donors who do not have a substantial amount or any U.S.-source income may not have much incentive to make donations to U.S. charities
- Certain types of U.S. charities would not be restricted to the donors' U.S.-source income
  - Gifts by Canadian commuters to certain U.S. charities
  - Gifts by Canadians to those U.S. charities that are listed as qualified donees under the Act: prescribed universities, entities to which the Crown have made gifts, agents of the United Nations

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**a) Canadian donors who are commuters**

- The person resides in Canada near the Canada-U.S. border
- The person commutes to his or her principal place of employment or business in the U.S., from where the person derives his/her chief source of income
- The donation is made to a U.S. religious, charitable, scientific, literary or educational charity created or organized under the laws of the U.S. - same as those entities that qualify under Article XXI(1) of the Treaty (but not all 501(c)(3) charities)

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**b) Prescribed universities**

- Canadian donors are permitted to make charitable donations to foreign universities prescribed to be a university if their student body ordinarily include students from Canada
- Pursuant to Regulation 3503, these universities are those named in Schedule VIII to the Act
- The qualifying entities must be the universities themselves, and that an entity, e.g., a centre or a foundation, whose activities and funds are dedicated to achieving the goals or the activities of a particular university would not qualify

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**c) Donee of Her Majesty in the Right of Canada**

- Canadian donors can make donations to charitable organizations outside of Canada to which Her Majesty in right of Canada has made gifts in the current year or in the previous calendar year
- The list is kept by CRA - last revised on Oct 6, 2006. [error on page 22 and footnote 82 of paper]
- CRA is responsible for determining whether the entity receiving a gift from the federal Crown is a “charitable organization” according to Canadian law, and whether the payment to the foreign entity is a “gift” at law

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**d) Agencies of the United Nations**

- Canadian donors are permitted to make charitable donations to the United Nations and its agencies
- U.S. charities that are considered to be “agencies” of the United Nations would fall within in this category
- It is not clear what entities are agencies of the United Nations for the purpose of the definition of qualified donees

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**ARTICLE XXI(1) – RECEIPT OF INCOME IN CANADA**

- Article XXI(1) of the Treaty permits certain U.S. charities to be exempt from Canadian income tax on certain income earned in Canada – requirements that must be met:
  - It must be a religious, scientific, literary, educational or charitable organization
  - It must be resident in the U.S.
  - Income derived in Canada is not derived from the carrying on of a trade or business or from a related person that is not an organization referred to in Articles XXI(1) or XXI(2)

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**1. Religious, scientific, literary, educational or charitable organization**

- The U.S. charity must demonstrate that it is a religious, scientific, literary, educational or charitable organization
- Section 501(c)(3) of the Code provides income tax exemption for eight enumerated organizations - only five are set out in Article XXI(1)
- The three enumerated categories that have not been included in Article XX(1) are:

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- “preventing cruelty to children or animals” would be recognized as charitable at common law
- “testing for public safety” - while the preservation of public order and protection of lives and property are generally recognized to be charitable at law in Canada, , it is not clear whether the “testing” for public safety would be charitable at law
- “fostering national or international amateur sports competition”- *A.Y.S.A Amateur Youth Soccer Association v. Canada*, on appeal to S.C.C. with the hearing date set for May 16, 2007

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**2. U.S. charities resident in the U.S.**

- In order to qualify for income to be exempt from tax in a contracting state under Article XXI(1), the U.S. charity in question must be resident in the U.S.

**3. Type of exempt-income**

- U.S. charities may derive income from various activities in Canada, e.g., membership fees, workshop and conference fees, sale of merchandise, interests, royalty fees, license fees, rental income, fees for rendering services, etc.

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- Whether income earned by U.S. charities in Canada would be exempt from Canadian income tax pursuant to Article XXI(1) of the Treaty would depend on whether the following restrictions set out in Articles XXI(1) are met:
  - Not income derived from carrying on a trade or business
  - Not income earned by a related person, unless that person is a U.S. charity referred to in Article XXI(1) or a pension, retirement or employee benefits plan to in Article XXI(2)
  - Only applies to income that is exempt from tax in the U.S.

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a) Carrying on trade or business

- Pursuant to Article XXI(3), the exemption in Article XXI(1) for income earned in Canada does not apply to income derived from carrying on a trade or business
- The phrase “carrying on a trade or business” is not defined in the Treaty
- It is a question of fact whether certain income is income from carrying on a trade or business
- CRA made reference to the same factors used for determining whether a non-profit organization under paragraph 149(1)(l) of the Act is carrying on a trade or business

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- Paragraph 7 of CRA’s Interpretation Bulletin IT-496R include the following factors:
  - It is a trade or business in the ordinary meaning, that is, it is operated in a normal commercial manner
  - Its goods or services are not restricted to members and their guests
  - It is operated on a profit basis rather than a cost recovery basis, or
  - It is operated in competition with taxable entities carrying on the same trade or business

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• CRA’s policy statement CPC-019 on related business also explains whether a particular activity of a charity is a business depends on the facts in each case. The following are some of the criteria established by the courts:

- The intended course of action
- The potential to show a profit
- The existence of profits in past years
- The expertise and experience of the person or organization that undertakes the activity

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• The related business policy further explains that “carrying on” a business implies that the commercial activity is a continuous or regular operation

- i) Solicitation of donations and selling of donated goods
- ii) Events that charges fees
- iii) Fundraising activities
- iv) Passive investments
- v) Income through partnership interest

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b) Income from related persons

- The exemption does not apply to income earned by a related person, unless that person is a U.S. charity referred to in Article XXI(1) or a pension, retirement or employee benefits plan referred to in Article XXI(2)
- c) Exempt income in the U.S.
  - Article XXI(1) provides that the exemption is limited only to such income that is exempt from tax in the U.S.

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- U.S. charities are subject to U.S. tax on their net income derived from their unrelated trade or business or business activities - income from a trade or business, regularly carried on, that is not substantially related to the charitable, educational or other purpose that is basis for the organization’s exemption
- CRA pointed out in its publication T4016 that in most cases, where income would be treated as “unrelated business income” under the Code, it is “probable” that CRA would conclude that the income so categorized is from carrying on a business

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**4. Recognition procedure**

- U.S. charities seeking Treaty benefits under Article XXI(6) of the Treaty can do so if they qualify under section 501(c)(3) of the Code. They do not need to apply to CRA, although they may have to show proof that they qualify under the Code [error on page 36 of paper]
- However, U.S. charities seeking benefit under Article XXI(1) of the Treaty, U.S. charities are required to submit an application to CRA’s International Tax Services Office

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**OTHER POSSIBLE EXEMPTIONS UNDER THE ACT**

- If relief from tax is not available under Article XII, there are a number of other provisions under which the U.S. charity may not be subject to tax in Canada:
  - If the income derived by the U.S. charity does not arise from a permanent establishment in Canada, or
  - If the U.S. charity qualifies as a non-profit organization in Canada

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**1. No permanent establishment in Canada**

- **Article VII(1) - business profits of a U.S. charity shall be taxable in Canada if it carries on business in Canada through a permanent establishment in Canada**
- **Article VII(1) - requires that the tax on the business profits of the U.S. charity is limited to those attributable to that permanent establishment**
- **In order to attract tax in Article VII, it requires three elements:**
  - **Business profits**

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- **A permanent establishment in Canada**
- **Profits attributable to the permanent establishment**

- **Therefore, if the income derived by a U.S. charity in Canada is not tax-exempt under Article XXI(1) of the Treaty, but the income does not meet the requirements in Article VII(1), it may not be subject to tax in Canada, provided that the income is not taxable under other provisions of the Treaty**

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**a) Business profits**

- **“Business profits” is not defined in the Treaty**
- **In general, it means profits earned in the course of carrying on a business**
- **Business profits are taxable under Article VII only to the extent that they are attributable to a permanent establishment (PE) of the U.S. charity in Canada**
  - **The business profits of a PE are determined as if the PE were a distinct and separate person engaged in the same or a similar activity under the same or similar conditions and dealing independently with the U.S. resident**

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- In determining the business profits, deductions for expenses, wherever incurred, are allowed for those incurred for the purpose of that PE
- The only business profits that can be attributable to a PE are those derived from the assets or activities of the PE
- Article VII(6) also provides that where business profits include items of income that are dealt with separately in other Articles of the Treaty, then those other Articles and not Article VII will govern the treatment of those types of income

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**b) Permanent establishment**

- Business profits are taxed pursuant to Article VII only if it is attributable to a PE
- PE is defined in Article V(1) to mean a fixed place of business through which the business of a resident of a contracting state is wholly or partly carried on
- To constitute a PE, three requirements must be met
  - There must be a place of business, facility or premises

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- That place of business, facility or premises must be fixed
- The business must be carried on through that place of business
- Therefore, when determining whether income earned by a U.S. would can be exempt from Canadian tax because the requirements in Article VII are not met, it would be necessary to review the facts of the case in relation to the U.S. charity, including the source of income earned, how income is earned, the activities of the U.S. charity in Canada, etc.

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**2. Non-profit organizations**

- **A U.S. charity may be exempt from income tax in Canada if it qualifies as a “non-profit organization” (“NPO”) under paragraph 149(1)(l) of the Act**
- **If a U.S. charity qualifies as an NPO in Canada**
  - **Exempt from Part I tax**
  - **Branch office in Canada will be exempt from branch tax under paragraph 219(2)(c) of the Act**

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- **May apply to CRA for a waiver in respect of withholding tax under Regulation 105 for services provided by a non-resident U.S. charity and for a waiver from Part XIII withholding tax**

- **Criteria which must be met:**
  - (a) **It is not a charity;**
  - (b) **It is organized and operated exclusively for social welfare, civic improvement, pleasure, recreation or any other purpose except profit;**
  - (c) **It does not distribute or otherwise make available for the personal benefit of a member any of its income**

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- **It is a question of fact whether the criteria are met – by reviewing the purposes and activities of the association on a year-by-year basis**
- **There is no requirement that an NPO must be resident in Canada (as opposed to the requirement that registered charities must be resident in Canada)**
- **If a U.S. charity has a branch office in Canada, the issue is whether the U.S. charity itself would qualify for NPO status, not simply whether the Canadian branch office would qualify for NPO status**

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- The Act requires that an NPO must not be a charity within the meaning of paragraph 149.1(1)(l) of the Act
- Not a registered charity
  - Registered charities must be resident in Canada and was either created or established in Canada
  - U.S. charities would not meet this residency requirement and therefore could not become registered charities in Canada
  - CRA indicated that the policy intent of this requirement is that the tax incentives for charities are to be used to support Canadian organizations

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- Not a charity at common law
  - CRA has accepted that a U.S. corporation could be recognized as a charity at common law for the purpose of paragraph 149.1(1)(l) of the Act, although they could not qualify for registration as registered charities because of the failure to meet the residency requirements of the Act
  - Therefore, U.S. charities that qualify as charities at common law would not qualify as NPOs

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**CONCLUSION**

- It is important for U.S. charities and their advisors to be familiar with the applicable provisions of the Treaty and the Act that may impact the ability of U.S. charities to receive donations from Canadians and the operations of U.S. charities in Canada
- However, if the benefits offered by the Treaty and the Act are not sufficient, then a U.S. charity may wish to consider establishing a parallel charity in Canada

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