
Financial Officer's Group
Scarborough – November 6, 2008

Surviving a CRA Audit

By Karen J. Cooper, LL.B., LL.L., TEP
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OVERVIEW

- Background
- Audit/Appeals Process
- Practical Considerations in Preparing for an Audit
- Top Ten Audit Issues

For more information see Charity Law Bulletin No. 82 “Changes to Sanctions, Penalties and Appeals Process For Charities” and No. 117 “Guidelines for Applying the New Intermediate Sanctions for Charities” at www.charitylaw.ca

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BACKGROUND

- New rules concerning the taxation and administration of charities set out in the March 2004 Federal Budget received Royal Assent on May 13, 2005 and are now in force:
 - New intermediate sanctions
 - New and more accessible appeals process
 - CRA’s internal appeals process
 - Tax Court of Canada

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- Previously, CRA had only one sanction – revocation
- There were relatively few audits
- Audits were usually reactive, not proactive
- Audits were performed by Consulting and Audit Canada, not CRA
- Budget brought increased resources to the Charities Directorate at CRA

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- On April 10, 2007, the Canada Revenue Agency (“CRA”) released a new policy document, “Guidelines for Applying the New Sanctions” (the “Guidelines”)
- The Guidelines set out CRA’s approach to audits and the application of the new intermediate sanctions resulting from the above amendments to the *Income Tax Act* (the “ITA”)
- The Guidelines can be accessed on the CRA’s website at the following link: <http://www.cra-arc.gc.ca/tax/charities/policy/newsanctions-e.html>

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- CRA’s general approach for audit program:
 - Education
 - Compliance agreements
 - Sanctions
 - Revocation of charity’s registration
- Substantial changes have been made during the last 6 years to the legislation governing the regulation of registered charities
- With its increased resources, CRA is more likely to conduct audits of registered charities

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AUDIT/APPEALS PROCESS

- 1. Organization is identified for audit**
 - Random selection
 - Legislative criteria/concerns
 - Follow-up on non-compliance or complaints
 - Audit of related organization
- 2. Office Audit - File is screened by Charities Directorate (entails a review of information on file with CRA and internet) and, if necessary, referred for a field audit**

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3. Field Audit

- On location
- Single or a team
- Examination of books and records relating to bank accounts, investments, expenses, contracts, annual reports, board minutes, and any other documents related to the charity's activities
- Not only an examination of financial affairs, also an examination to determine compliance with legal obligations under the ITA and if operating for charitable purposes

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4. Audit Report is prepared

- 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
- Generally, preliminary findings will be communicated in advance to the charity
- The audit report is a key document for the organization to obtain because it details the audit findings and the legal basis of any assessment of sanctions

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5. Letter to charity advising of results

- **Education – minor non-compliance**
 - i.e. An education letter specifically addressed to a charity explaining its obligations under the ITA
- **Compliance Agreement (formerly undertaking letter)**
 - **Corrective action required: agreement outlines non-compliance and remedial actions that the charity must undertake and includes a paragraph that advises the charity that a penalty and/or suspension could apply if the agreement is not upheld**

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- **Formal document that is negotiated, signed and dated by both parties, includes a timeframe to make changes outlined in the agreement**
- **The compliance agreement needs to be approved by the board of the charity and it is an extremely important document**
- **If a charity does not fulfilled its obligations as set out in an education letter or under a compliance agreement or if the audit findings are sufficiently serious, CRA may proceed in applying the relevant sanction**

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6. Follow-up

- **CRA may bring file forward for automatic review to ensure compliance with the agreement**
- **May be by office or field audit**
- **If compliant, file likely closed**
- **If non-compliant, maybe application of intermediate sanctions**

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7. Application of Intermediate Sanctions

- **The CRA’s General Approach to Sanctions**
 - **The guidelines state that 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**
 - **In cases of serious non-compliance, the CRA intends to move directly to the imposition of a sanction or revocation**

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- **The Guidelines identify examples of serious non-compliance**
 - **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* or other quasi-criminal statutes**
 - **Where non-compliance involves violations of central provisions of the ITA**
 - **Where charity is not acting in accordance with the terms of a compliance agreement**

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- **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**
 - **The charity is either unable or unwilling to bring itself into compliance**

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- **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**
 - **Where there is no appropriate sanction for a serious breach, e.g., engaging in non-charitable activities**

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Offence	CRA Discretion (As Per the Guidelines)	First Infraction	Repeated Infraction (Within 5 years)
• Late filing or failure to file T3010A	• CRA will send a "reminder to file" notice to charities one month before filing deadline	• May lead to revocation • \$500 penalty on re-registration	• May lead to revocation • \$500 penalty on re-registration
• Issuing incomplete receipts	• Compliance agreement (unless serious infraction)	• Penalty of 5% of eligible amount stated on receipt	• Penalty of 10% of eligible amount stated on receipt
• Carrying on prohibited business activity • Private foundation - any business • Public foundation or charitable organization - unrelated business	• Compliance agreement • Provide opportunity to cease carrying on prohibited business activity	• Penalty of 5% on gross revenue from the offending activity	• Penalty of 100% on gross revenue from the offending activity and suspension of receipt privileges for one year
• Foundation acquiring control of corporation	• Compliance agreement (unless serious infraction)	• 5% penalty on dividends paid by corporation	• 100% penalty on dividends paid by corporation

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Offence	CRA Discretion (As Per the Guidelines)	First Infraction	Repeated Infraction (Within 5 years)
• Failure to comply with certain verification and enforcement requirements (e.g. keeping proper books and records)	• Generally, compliance agreement • Sanctions or even revocation for more serious infractions	• Suspension of tax receiving privileges for one year	• Suspension of tax receiving privileges for one year
• Issuing receipts in taxation year if there is no gift or if receipt contains false information	• CRA likely to proceed directly to revocation	• 125% penalty on eligible amount of receipts (suspension of tax receiving privilege of total penalties under 188.1(9) exceeds \$25,000 in a taxation year) • If also subject to penalty under s.163.2 of ITA, the person is subject to whatever penalty is larger	• 125% penalty on eligible amount of receipts (suspension of tax receiving privilege of total penalties under 188.1(9) exceeds \$25,000 in a taxation year) • If also subject to penalty under s.163.2 of ITA, the person is subject to whatever penalty is larger

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Offence	CRA Discretion (As Per the Guidelines)	First Infraction	Repeated Infraction (Within 5 years)
• Inter-charity gifting to delay disbursement quota	• CRA will proceed directly to penalty	• Penalty of 100% of amount transferred • Both charities subject to the penalty (CRA has the discretion to split penalty between charities)	• Penalty of 100% of amount transferred • Both charities subject to the penalty (CRA has the discretion to split penalty between charities)
• Gifts to non-qualified donee	• Compliance agreement (unless serious infraction)	• Penalty is 105% of the amount gifted to non-qualified donee	• Penalty is 110% of the amount gifted to non-qualified donee
• Undue personal benefit	• Compliance agreement (unless serious infraction)	• Penalty of 105% of benefit	• Penalty of 110% of benefit and suspension of tax receipt privileges for one year
• Failure to divest of excess business holdings (private foundations only)		• Penalty of 5% of value of excess holdings (doubled if failure to disclose information)	• Penalty of 10% of value of excess holdings (doubled if failure to disclose information)

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- **If a sanction is being contemplated, the Charities Directorate will inform the charity in writing and the charity will then have 30 days in which to respond to explain why it should not be subject to the proposed sanction**
- **The Charities Directorate will then decide whether to impose a sanction and notify the charity accordingly**
- **The charity can make payment to CRA or an eligible donee (another arm's length charity) and return sign off form to CRA once payment has been made**
- **Or the charity can appeal (see below)**

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- 8. Revocation**
- **Revocation is always available as a option for CRA for any offence at any time and can be applied with intermediate sanctions or separately**
 - **The charitable status of a charity may also be revoked if it obtained its charitable registration on the basis of false, misleading or omitted information**

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9. Internal Appeal

- **An Internal Appeal process is now available for both sanctions and revocation**
- **Must file a Notice of Objection with the Assistant Commissioner of CRA’s Appeals Branch within 90 days of the date of the decision’s mailing**
- **Notice of Objection should identify the decision objected to, the reasons for the objection and all relevant facts**
- **Reviewed by an officer in the Charities Redress Section of the Appeals Branch of CRA, separate from the Charities Directorate**

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- **Following the review and with the delegated authority of the Minister, Managers at the Tax & Charities Appeals Directorate may maintain, vary or disagree with the original decision**
- **Notice of objection is required before an appeal may be brought to the Courts**

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10. Appeal to Court

- **Suspensions and Stays**
 - **If a suspension is invoked, the charity may apply to the Tax Court of Canada to postpone the application of the suspension**
 - **In situations of “aggravated non-compliance” resulting in a direct move toward revocation, a charity has 30 days in which to file a stay with the Federal Court of Appeal**

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- Appeals
 - Tax Court: appeals of intermediate sanctions
 - A charity must appeal CRA’s decision to impose a sanction within 90 days of notification of the decision being made
 - Federal Court of Appeal: application for judicial review of refusals to register, revocation, annulment, and charitable designation
 - A charity must appeal the CRA’s decision on an objection within 30 days of notification of the decision being made

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11. Payment of Penalty

- Where a penalty is greater than \$1000 the charity may 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 intermediate sanction by CRA
- Arm’s length – more than 50% of directors deal at arms length with all directors of the sanctioned charity

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12. Annulment

- Where registration obtained in error or if charity ceases to be a charity because of changes in the law
 - No effect on issued receipts
 - No 100% Part V revocation tax or other penalty will be charged
- Useful tool – permits errors to be rectified without negative public notice which goes with notice of revocation

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**PRACTICAL CONSIDERATIONS IN
PREPARING FOR AN AUDIT**

1. General Approach

- Perfection is not expected or required
- But need to exercise due diligence
- Therefore need to be prepared in advance of the audit

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2. Knowledge

- Attend seminars and other educational opportunities
- Registered Charities Newsletters
- www.charitylaw.ca
- <http://www.cra-arc.gc.ca/tax/charities/>

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- Charities need to know and understand their obligations with respect to the likely audit issues before being able to ensure compliance
- Ignorance will not be a defence
- Document uncertainty and steps taken to seek clarification

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3. Books and Records

- Charities will be required to produce the following:
 - Copies of T3010s, as filed with attachments
 - Financial statements
 - Books and records (general ledger, cash receipt/disbursement journals, working papers)
 - Listing of bank accounts with all statements, cancelled cheques and deposit books

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- Listing of all cash donation receipts including the receipt number, name of donor, and amount reconciled to the financial statements and bank deposits
- Listing of all gift-in-kind donation receipts including the receipt number, name of donor, description, FMV of property, eligible amount. For gifts which were appraised (over \$1,000), name and address of appraiser, who/how appraiser was selected, and what information was compiled before accepting the appraised value

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- Duplicates of all receipts
- Reconciliation and breakdown of expenditure reported (line 120/5000 of T3010)
- All expense source documentation (contacts, invoices, receipts, statements, cancelled cheques)
- Note: instructions to auditors require that the source documentation must be in the name of the Charity for the expense to be allowed, particularly if meeting & accommodation, meals or entertainment
- Details of the charity's activities supported by copies of brochures, pamphlets, publications, membership and fundraising correspondence, newsletters, etc.

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- Governing documents, i.e. Constitution, Letters Patent and Supplementary Letters Patent, By-Laws
- Official updated Minute Book
- Listing of Directors/Trustees, their positions, occupations, relationship to others, details of any remuneration or other compensation received (including reimbursement of expenses)
- Payroll documentation (T4s)
- Agency/consulting agreements

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- 4. Audit Day**
- The auditor is not your friend (or enemy)
 - ITA 231.1 requires “all reasonable assistance”
 - Disclose only required information
 - Be responsive
 - Make auditor comfortable
 - Consider requesting written questions
 - Document/demonstrate efforts to comply

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- 5. Other strategies**
- Ensure that board approval is obtained for changes to charitable programs and consider obtaining CRA approval
 - Review charitable objects regularly and provide CRA with changes to governing documents
 - Review and comply with document retention requirements
 - Consider obtaining board approval of T3010s

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- **Avoid excessive salaries, fundraising contractors and fees (document due diligence and comparisons)**
- **Grants to foreign charities – ensure appropriate agency agreements are in place**
- **Protect privileged documents (communications related to obtaining legal advice, does not include accountants or consultants)**

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CRA's TOP TEN AUDIT ISSUES

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- 1. Incorrect Issuance of Receipts**
- **Registered charities are often unaware of requirements for contents of receipts**
 - **Registered charities often make mistakes as to what type of property is receiptable**
 - **Receipts are often incorrectly issued for services**
 - **Establishing FMV also tends to be a hurdle for charities**

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- **Income Tax Regulation 3501 requires:**
 - Name, Registration # and address of charity
 - Serial # of receipt
 - Date and place of issue
 - Date of receipt of cash gift
 - Date of receipt and description of in-kind gift
 - Value of property received
 - Amount of advantage received by donor
 - CRA name and website URL
- See CRA Website for most recent requirements

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- **Avoid False Receipts**
 - Avoid one receipt at end of the year if multiple gifts
 - Obtain own independent valuation
 - Know your donors: Neither valuator nor charity should turn a blind eye to facts or circumstances which may give rise to concerns
- Avoid others issuing fraudulent receipts - be diligent in safeguarding the charity's receipts and report any suspected fraud immediately to the CRA

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- 2. Failure to File T3010**
- Continues to be the biggest compliance issue
 - Thousands of charities file late each year or fail to file and are revoked as a consequence
 - In an effort to increase compliance, in addition to the \$500 late filing penalty, a reminder to file notice is sent to charities one month prior to the annual information return's due date

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- A registered charity must file an annual information return with CRA within 6 months of its year end
 - The annual information return includes the T3010A form, a basic information sheet, and financial statements of the institute
 - The public portion of the T3010A return and all of the financial statements will be made available to the public on the CRA website

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- The T3010 forms that CRA receives are often completed incorrectly or are missing information entirely
- Line 5000 (charitable program expenditures) has consistently been omitted by hundreds of charities since 2003
- Other problem areas:
 - Eligible amount of tax-receipted gifts
 - Amounts received from other registered charities
 - Recording specified gifts
 - Enduring property (receipt and expenditure)

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3. Non - Charitable Activities

- A registered charity's purposes must fall within one or more of the following four charitable purpose categories:
 - The relief of poverty
 - The advancement of education
 - The advancement of religion
 - Other purposes that are beneficial to the public as determined by the courts
- No amount of the organization's income can be available to its members for their personal, as opposed to charitable purposes
 - An exception exists for reasonable salaries or the reimbursement of out-of-pocket expenses

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4. Gifts to Non-Qualified Donees

- **Registered charities tend to be unaware of the restrictions surrounding “qualified donees”**
- **Registered charities may use their resources in one of two ways:**
 - **Own charitable programs, or**
 - **By gifts to qualified donees**

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- **Qualified donees:**
 - **Registered Canadian charities**
 - **The United Nations**
 - **Federal, provincial and municipal governments**
 - **Prescribed foreign universities**
 - **Foreign charities to which the federal Crown has made a gift**

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- **Gifts to organizations that are not qualified donees is a serious issue:**
 - **There are monetary penalties which apply (105% of amount gifted)**
 - **Also a common ground for revocation**
- **Confirming an organization’s status as a registered charity is easy through the CRA’s website or by calling the Charities Directorate**

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- Where registered charities conduct activities abroad through an intermediary, they often do not have a properly structured agreement (containing all the necessary elements required by the CRA) in place to help demonstrate direction and control
- Frequently, even when an agreement is in place, charities often fail to properly implement and monitor the arrangement

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5. Fundraising

- From the media’s perspective this is a number one compliance issue
- While the CRA accepts that charities can have fundraising costs, its expectation is that these expenses be reasonable and proportionate to the charitable activity being conducted

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- A charity which spends excessive amounts on fundraising to the detriment of its charitable programs is not considered to be devoting all of its resources to charitable activities
- Additionally, spending excessive amounts on fundraising results in disbursement quota shortfalls and often deliberate, incorrect categorization of expenses (i.e., including fundraising expenses as a charitable program expenditure)

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- **On March 31, 2008, CRA released a Consultation Paper for a Proposed Policy on Fundraising (“Fundraising Policy”) to provide registered charities with information pertaining to the use of resources for fundraising and the limits imposed by law**

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6. Political Purposes and Activities

- **Charities cannot operate for political purposes but can carry on limited amounts of non-partisan political activity**
- **CRA has issued a Policy Statement, CPS-22, which details the limits on a registered charity’s ability to carry on political activity**

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7. Unrelated Business Activities

- **Registered charities can carry on limited business activities provided that they are linked to and subordinate to their charitable programs**
- **Problems usually emerge when a charity develops a new fundraising program or can often occur where a charity’s focus shifts and an existing fundraising program becomes a purpose in and of itself rather than a means to an end**
- **Unrelated businesses are commonly seen in activities like tournaments and events, gaming activities and sale and rental of properties**

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8. Religious Tuition

- Schools that are also registered charities may issue receipts for tuition in two circumstances:
 - The school teaches exclusively religion
 - The school operates in a dual capacity (provides secular and religious education)
- Receipts may be issued for the religious portion of tuition, which, in the case of dual capacity schools, is based on the calculation set out in IC 75-23
- The CRA often finds that charities are not taking care to properly apportion (and document) the amount of tuition devoted to religious instruction - resulting in inflated tax receipts

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9. Tax Shelters

- Popularity has increased dramatically and as a result these arrangements have become a serious concern
- To date 26,000 taxpayers have been audited and about \$1.4 billion in claimed donations have been denied
- Audits of another 70,000 taxpayers are at various stages of completion. Disallowed donations in these cases are expected to exceed an additional \$1.8 billion
- Charities involved may face revocation

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10. Transactions with Directors

- A charity's assets should be protected and used only for the benefit of the charity's programs
- Transactions with directors are more closely scrutinized by the CRA to ensure that they are "above-board"
- Salaries, loans to directors, investments in companies of directors, transactions with businesses owned by directors, etc. are common areas of concern

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Other CRA rules

- Registered charities must be aware that their responsibilities with the CRA do not start and end with their tax receipts and charitable filings
- For example, registered charities have a responsibility to maintain a payroll account and report taxable benefits where applicable
- GST is also a responsibility of a charity – some charities depending on the types of supplies they make and their size (based on gross revenue) need to register for GST

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