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# ONTARIO BAR ASSOCIATION

Charity and Not-for-Profit Law Section Meeting

Toronto – April 5, 2011

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## How to Prepare Your Client for a CRA Audit

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**ONTARIO BAR ASSOCIATION**  
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Meeting  
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**How to Prepare Your Client  
for a CRA Audit**

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2

**BACKGROUND**

- Various federal budgets since 2004 have increased CRAs regulatory authority with respect to registered charities and, most recently, qualified donees
  - Intermediate sanctions
  - New appeals process
    - Internal appeals
    - Tax Court of Canada

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- Extended to certain qualified donees
  - RCAAAs
  - Municipalities
  - Housing corporations
  - Municipal and public bodies performing a function of government in Canada
- Strengthened anti-avoidance measures throughout ITA

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- Previously, CRA had only one sanction – revocation
- There were relatively few audits
- Audits were usually reactive, not proactive
- Budgets have brought increased resources to the Charities Directorate at CRA
- With its increased resources, CRA is more likely to conduct audits of registered charities

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- On April 10, 2007, CRA released a policy document, "Guidelines for Applying the New Sanctions" (the "Guidelines")
- The Guidelines set out CRA's approach to audits, the application of the intermediate sanctions, and the decision to revoke
- The Guidelines can be accessed on the CRA's website at <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/ Annulment
- See also *Auditing Charities* (T4118) available at <http://www.cra-arc.gc.ca/E/pub/tg/t4118/t4118-08-e.html>

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- CRA indicated in a recent compliance update:
  - Ongoing audits of tax shelters - since 2003 there has been approximately 72,300 participants audited in respect of \$5.4 billion in donations
  - False receipting remains a significant problem - 100,000-135,000 donors reassessed since 2005 for about \$290 million
  - CRA audit activity for the fiscal year 2009-10:
    - Total number of audits: 719
    - Total revocations for cause: 41

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- The NPO Risk Identification Project is gathering information on non-profit organizations to assist in determining "the level of non-compliance, any significant data gaps that may require mandatory filing of prescribed forms, and whether recommendations to the Department of Finance for more robust legislation are necessary"
- See CRA Roundtable at the 2010 Canadian Tax Foundation Conference, slides 60-62

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9

**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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10

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 organization'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 or non-profit purposes

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11

4. Audit Report is prepared

- Generally, preliminary findings will be communicated in advance to the organization
- 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
- 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

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12

5. Letter to charity advising of results

- Can take different forms
- Education – minor non-compliance
  - An education letter specifically addressed to a charity explaining its obligations under the ITA

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13

- 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 qualified donee that a penalty and/or suspension could apply if the agreement is not upheld
  - 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
  - Beware of admissions

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14

- Administrative Fairness Letter ("AFL")
  - If the qualified donee has not fulfilled its obligations as set out in a previous education letter or compliance agreement or if the audit findings are sufficiently serious, CRA may proceed to give notice of its intention to apply the relevant sanction or revocation
  - Usually 30 to 90 days to provide submission, depending

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15

- 6. Follow-up (Education or Compliance)
  - 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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16

7. Application of Intermediate Sanctions

- CRA's general approach to sanctions
  - The guidelines state that most cases of non-compliance related to issues which can be sanctioned under the 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
  - Query whether approach will be the same with respect to qualified donees

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17

- 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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18

- 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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19

- 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 & tax shelter participation
- Query whether approach will be similar with respect to new governance requirement (serious vs aggravated non-compliance or no-tolerance)

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20

Offence	CRA Discretion (As Per the Guidelines)	First Infraction	Repeated Infraction (Within 5 years)
<ul style="list-style-type: none"> <li>• Late filing or failure to file T3010A (or T2 if RCAA)</li> </ul>	<ul style="list-style-type: none"> <li>• CRA will send a "reminder to file" notice to charities one month before filing deadline</li> </ul>	<ul style="list-style-type: none"> <li>• May lead to revocation</li> <li>• \$500 penalty on re-registration</li> </ul>	<ul style="list-style-type: none"> <li>• May lead to revocation</li> <li>• \$500 penalty on re-registration</li> </ul>
<ul style="list-style-type: none"> <li>• Issuing incomplete receipts (QDs)</li> </ul>	<ul style="list-style-type: none"> <li>• Compliance agreement (unless serious infraction)</li> </ul>	<ul style="list-style-type: none"> <li>• Penalty of 5% of eligible amount stated on receipt</li> </ul>	<ul style="list-style-type: none"> <li>• Penalty of 10% of eligible amount stated on receipt</li> </ul>
<ul style="list-style-type: none"> <li>• Carrying on prohibited business activity                             <ul style="list-style-type: none"> <li>• Private foundation - any business</li> <li>• Public foundation or charitable organization (RCAA) - unrelated business</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>• Compliance agreement</li> <li>• Provide opportunity to cease carrying on prohibited business activity</li> </ul>	<ul style="list-style-type: none"> <li>• Penalty of 5% on gross revenue from the offending activity</li> </ul>	<ul style="list-style-type: none"> <li>• Penalty of 100% on gross revenue from the offending activity and suspension of receipt privileges for one year</li> </ul>
<ul style="list-style-type: none"> <li>• Foundation acquiring control of corporation</li> </ul>	<ul style="list-style-type: none"> <li>• Compliance agreement (unless serious infraction)</li> </ul>	<ul style="list-style-type: none"> <li>• 5% penalty on dividends paid by corporation</li> </ul>	<ul style="list-style-type: none"> <li>• 100% penalty on dividends paid by corporation</li> </ul>

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21

Offence	CRA Discretion (As Per the Guidelines)	First Infraction	Repeated Infraction (Within 5 years)
<ul style="list-style-type: none"> <li>• Failure to comply with verification and enforcement requirements (e.g. keeping proper books and records) (QDs)</li> </ul>	<ul style="list-style-type: none"> <li>• Generally, compliance agreement</li> <li>• Sanctions or even revocation for more serious infractions</li> </ul>	<ul style="list-style-type: none"> <li>• Suspension of tax receiving privileges for one year</li> </ul>	<ul style="list-style-type: none"> <li>• Suspension of tax receiving privileges for one year</li> </ul>
<ul style="list-style-type: none"> <li>• Issuing receipts in taxation year if there is no gift or if receipt contains false information (QDs?)</li> </ul>	<ul style="list-style-type: none"> <li>• CRA likely to proceed directly to revocation</li> </ul>	<ul style="list-style-type: none"> <li>• 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)</li> <li>• If also subject to penalty under s. 163.2 of ITA, the person is subject to whatever penalty is larger</li> </ul>	<ul style="list-style-type: none"> <li>• 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)</li> <li>• If also subject to penalty under s. 163.2 of ITA, the person is subject to whatever penalty is larger</li> </ul>

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Offence	CRA Discretion (As Per the Guidelines)	First Infraction	Repeated Infraction (Within 5 years)
<ul style="list-style-type: none"> <li>Inter-charity gifting to delay disbursement quota</li> <li>Gifts to non-qualified donee</li> <li>Undue personal benefit (RCAAs)</li> <li>Failure to divest of excess business holdings (private foundations only)</li> </ul>	<ul style="list-style-type: none"> <li>CRA will proceed directly to penalty</li> <li>Compliance agreement (unless serious infraction)</li> <li>Compliance agreement (unless serious infraction)</li> </ul>	<ul style="list-style-type: none"> <li>Penalty of 100% of amount transferred</li> <li>Both charities subject to the penalty (CRA has the discretion to split penalty between charities)</li> <li>Penalty is 105% of the amount gifted to non-qualified donee</li> <li>Penalty of 105% of benefit</li> <li>Penalty of 5% of value of excess holdings (doubled if failure to disclose information)</li> </ul>	<ul style="list-style-type: none"> <li>Penalty of 100% of amount transferred</li> <li>Both charities subject to the penalty (CRA has the discretion to split penalty between charities)</li> <li>Penalty is 110% of the amount gifted to non-qualified donee</li> <li>Penalty of 110% of benefit and suspension of tax receipt privileges for one year</li> <li>Penalty of 10% of value of excess holdings (doubled if failure to disclose information)</li> </ul>

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23

- 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 – Notice of Sanction or Suspension
- 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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24

8. Notice of 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
- CRA may also be revoking qualified donee status

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25

9. Internal Appeal

- An internal appeals process is now available for both sanctions and revocation
- If a registered charity, 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
- If an NPO, the Notice of Objection goes to the Chief of Appeals of the local tax services office within 90 days
- Query if an NPO that is a qualified donee?

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- Notice of Objection should identify the decision objected to, the reasons for the objection and all relevant facts
- Following the review and with the delegated authority of the Minister, appeals officers (Charities Redress or TSO) 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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27

10. Appeal to Court

- Suspensions and Stays
  - If a suspension is invoked, the charity (QD?) 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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28

- Appeals
  - Tax Court: appeals of intermediate sanctions
    - A charity (QD?) 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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29

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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31

**KEY STATUTORY OBLIGATIONS RELATED TO AUDITS**

- Books and records – ss. 230(2)
 

*Every registered charity and registered Canadian amateur athletic association shall keep records and books of account at an address in Canada ... containing*

  - (a) *information in such form as will enable the Minister to determine whether there are any grounds for the revocation of its registration under this Act;*
  - (b) *a duplicate of each receipt containing prescribed information for a donation received by it; and*
  - (c) *other information in such form as will enable the Minister to verify the donations to it for which a deduction or tax credit is available under this Act.*

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32

- Audit authority – ss. 231.1(1)
 

*An authorized person may, at all reasonable times, for any purpose related to the administration or enforcement of this Act,*

  - (a) *inspect, audit or examine the books and records of a taxpayer and any document of the taxpayer or of any other person that relates or may relate to the information that is or should be in the books or records of the taxpayer ...*

*and for those purposes the authorized person may*

  - (d) *require ... any other person on the premises or place to give the authorized person all reasonable assistance and to answer all proper questions relating to the administration or enforcement of this Act ...*

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- Requirements – ss.231.2(1)
 

*Notwithstanding any other provision of this Act, the Minister may, subject to subsection (2), for any purpose related to the administration or enforcement of this Act ... by notice served personally or by registered or certified mail, require that any person provide, within such reasonable time as stipulated in the notice,*

  - (a) *any information or additional information, including a return of income or a supplementary return; or*
  - (b) *any document.*
- Search warrants – s.231.3

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34

**PRACTICAL CONSIDERATIONS IN PREPARING A CLIENT 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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35

- 2. Knowledge
  - Attend seminars and other educational opportunities
  - Registered Charities Newsletters
    - [www.charitylaw.ca](http://www.charitylaw.ca)
    - <http://www.cra-arc.gc.ca/tax/>
  - Imagine Canada – Charity Tax Tools

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36

- Advisors of charities and non-profits 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
- Organizations should document uncertainty and steps taken to seek clarification

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37

3. Books and Records

- Organizations will be required to produce the following:
  - Copies of T3010s or other tax returns, 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 all expenditures reported
- 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 organization for the expense to be allowed, particularly if meeting & accommodation, meals or entertainment*
- Details of the organization'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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- Depending upon the activities of the organization or areas of concern:
  - Copies of agreements related to the transfer of funds outside Canada
  - Documents supporting fundraising expenses, e.g. fund development plans, compensation to in-house and external fundraisers, campaign material, etc.
  - Timesheets or other documentation related to the allocation of staff time on such as political activities, related business, fundraising, etc.

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42

- Review checklists of required documentation and retention/destruction periods:
  - Books and records checklist available at <http://www.cra-arc.gc.ca/chrts-qvng/chrts/chcklsts/bks-eng.html>
  - IC78-10R5, Books and Records Retention/Destruction
  - Registered Charities Newsletter No. 26
  - *Income Tax Regulations*, section 5800
- **ENSURE RECORDS ARE IN CANADA BEFORE AUDIT BEGINS!!!**

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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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44

5. Other strategies

- Ensure that board approval is obtained for changes to programs and consider obtaining CRA approval
- Review corporate objects regularly and provide CRA with changes to governing documents
- Review and comply with document retention requirements
- Consider obtaining board approval of returns

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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 FOR CHARITIES/QUALIFIED DONEES**

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1. Incorrect Issuance of Receipts

- Organizations 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

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48

- *Income Tax Regulations*, ss. 3501(1) requires:
  - Name, Registration # and address
  - 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
- For QDs, ss. 3501(1.1) is largely similar
- See CRA Website for most recent requirements

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49

- Avoid false receipts
  - 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 organization'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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51

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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52

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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53

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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- CPS-028, *Fundraising by Registered Charities* available at <http://www.cra-arc.gc.ca/>
  - The Guidance focuses on the calculation of fundraising ratio, i.e., the ratio of fundraising costs compared to fundraising revenue on an annual basis
  - The ratio will place a charity in 1 of 3 categories

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- Under 35%: Unlikely to generate questions or concerns by CRA
- 35% to 70%: CRA will examine the average ratio over recent years to determine if there is a trend of high fundraising costs requiring a more detailed assessment of expenditures
- Above 70%: This will raise concerns with CRA and the charity must be able to provide an explanation and rationale for this level of expenditure, otherwise it will not be acceptable

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- Seven best practice indicators that will decrease the risk of CRA finding unacceptable fundraising
  1. Prudent planning processes
  2. Appropriate procurement processes
  3. Good staffing processes
  4. Ongoing management and supervision of fundraising practice
  5. Adequate evaluation processes

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57

6. Use made of volunteer time and volunteered services or resources
  7. Disclosure of fundraising costs, revenues and practice
- See also Office of the Public Guardian and Trustee, *Charitable Fundraising: Tips for Directors and Trustees*  
<http://www.attorneygeneral.jus.gov.on.ca/english/familv/pgt/charbullet/bulletin-8.asp>

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58

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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59

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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61

9. Tax Shelters

- Popularity has increased dramatically and as a result these arrangements have become a serious concern
- Charities involved have largely faced revocation

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62

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
- Now also new governance requirements

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63

**AUDIT ISSUES FOR NPOs**

- Operating on a for-profit basis
  - Excessive surpluses
  - Investment activities
  - Carrying on a trade or business through an NPO
    - zero-based budgeting, incidental profits...
- Benefits to members

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**OTHER CRA ISSUES**

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

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