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**Foreign Activities: How to Get Ready for a
CRA Audit**

By Terrance S. Carter, B.A., LL.B., TEP, Trade-mark Agent

tcarter@carters.ca
1-877-942-0001

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Ottawa · Toronto
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Toll Free: 1-877-942-0001

	<p>Canadian Council of Christian Charities 40th Anniversary CCCC Leadership & Stewardship Conference Richmond, B.C. – September 25 2012</p>
<p>Foreign Activities: How to Get Ready for a CRA Audit</p> <p>By Terrance S. Carter, B.A. LL.B., TEP, Trade-mark Agent tcarter@carters.ca 1-877-942-0001</p> <p>© 2012 Carters Professional Corporation</p>	
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<p>A. INTRODUCTION</p> <ul style="list-style-type: none">• Charities that are involved in foreign activities are particularly susceptible to audits by CRA• The onus is upon the charity carrying on activities outside of Canada to evidence that they have fully complied with CRA requirements• In this regard, failure to produce adequate books and records to the satisfaction of CRA can lead to sanctions and/or revocation of charitable status• The time to prepare for a CRA audit is well in advance of the audit, since there would be insufficient time to do so once a CRA gives notice that an audit will occur	
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<ul style="list-style-type: none">• In order to assist charities involved in foreign activities to be prepared for a CRA audit, this presentation will cover the following topics:<ul style="list-style-type: none">– A review of basic CRA requirements for charities engaged in foreign activities– How to carry out a “pre-audit” compliance review to identify areas of weakness and how to remedy them– Identification of problems that can occur on a CRA audit and how to avoid them	
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B. REVIEW OF BASIC CRA REQUIREMENTS IN CARRYING OUT FOREIGN ACTIVITIES

- CRA Guidance on Canadian Registered Charities Carrying Out Activities Outside of Canada, CG-002 is available at <http://www.cra-arc.gc.ca/chrts-gvng/chrts/plcy/cgd/tsd-cnd-eng.html>
- Although it will not be discussed today, charities also need to be aware of a related CRA Guidance, Using An Intermediary to Carry Out a Charity's Activities Within Canada CG-004 <http://www.cra-arc.gc.ca/chrts-gvng/chrts/plcy/cgd/ntrmdry-eng.html?rss>
- See Carters Charity Law Bulletins #219 and #259 for more information on these CRA Guidances at www.carters.ca/pub/bulletin/charity/2010/chylb219.htm and www.carters.ca/pub/bulletin/charity/2011/chylb259.htm

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- A registered charity may only use its resources in one of two ways:
 - 1) In making gifts to qualified donees. In order to become a qualified donee, an organization must be one of the following:
 - A registered charity (including a registered national arts service organization)
 - A registered Canadian amateur athletic association
 - A listed housing corporation resident in Canada constituted exclusively to provide low-cost housing for the aged
 - A listed Canadian municipality

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- A listed municipal or public body performing a function of government in Canada
- A listed university outside Canada that is prescribed to be a university, the student body of which ordinarily includes students from Canada
- A listed charitable organization outside Canada to which Her Majesty in right of Canada has made a gift
- Her Majesty in right of Canada or a province
- The United Nations and its agencies

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- 2) Carrying on its own activities
 - Those activities which are directly under the charity's control and supervision and for which it can account for any funds expended
 - The charity is actively involved in programs that are intended to achieve its charitable purposes (e.g. directly funding its own employees and/or volunteers in carrying out its programs)
 - Charities cannot carry out its charitable purposes by simply giving monies or other resources to an other organization that is not a qualified donee

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- CRA permits charities to make payments outside of Canada to and work with foreign counterparts (i.e. an "intermediary" – a person or non-qualified donee that is separate from the charity and who the charity works with to carry out its activities)
- However, before working with an intermediary and throughout the course of the arrangement, the charity will need to investigate the status and activities of the intermediary to ensure:
 - The intermediary has the capacity to carry out the charity's activity (e.g. personnel, experience, etc.)
 - There is a strong expectation the intermediary will use the charity's resources as directed by the charity

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- Must also do appropriate due diligence of intermediary concerning anti-terrorism compliance issues
- The Guidance states:

"When working through an intermediary, a charity must direct and control the use of its resources...A charity that does not **direct and control** its resources when working through an intermediary risks sanctions under the *Income Tax Act*, including the revocation of registered status." (Emphasis added)

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- A charity cannot simply act as a “conduit”
 - A conduit is an organization that accepts donations for which it typically issues tax-deductible receipts and then funnels the money, without maintaining direction and control, to a non-qualified donee
 - To avoid being a conduit, the Canadian charity must have demonstrable control over the use of its money
- A charity may use its spending on activities carried out through an intermediary to meet its 3.5% disbursement quota

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- Examples of amounts spent on charitable activities include:
 - The costs of goods transferred to an intermediary to provide eligible beneficiaries with charitable relief
 - Payments for buying goods and services to provide eligible beneficiaries with charitable relief
- A charity should report amounts spent by its intermediaries on its behalf as if they had been spent by the charity itself on Form T3010, Registered Charity Information Return
- There are four common types of intermediaries that can be used - CRA does not recommend using one type of intermediary over the other

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1) Agents

- In an agency relationship, a registered charity can appoint an agent to act as its representative to carry out specific tasks on behalf of the charity
- An agent is used when the charity cannot send its staff to a region to carry out an activity
- The charity relies entirely on the agent to carry out its activities on its behalf
- Agents can be organizations or individuals and do not need to be qualified donees under the ITA or registered charities in their own country
- The common law principle that the acts of the agent are that of the principal does not automatically meet the own activities test unless the charity is in fact directing what the agent does

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- A charity may have one general agency agreement that covers most of the terms in a relationship with its intermediary as well as additional directions that are specific for each particular activity
- Liability concerns:
 - The actions of the agent are deemed to be the actions of the principal, and as a result, the principal is vicariously responsible for the actions of the agent
 - Vicarious liability can expose a registered charity to significant liability, both civil and criminal (e.g. anti-terrorism legislation)
 - CRA warns charities to consider how they structure agency arrangements because the existence of an agency relationship could expose them to significant liability for their agents' acts

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- Insurance concerns:
 - Some insurers may be concerned about vicarious liability risks associated with agency relationships
 - Unless these risks are disclosed to the insurer, they may not be covered by insurance policies
 - A charity should advise its insurer in writing of the nature and extent of its agency relationships
- Disbursement quota concerns:
 - Until the agent spends funds from the charity, there is no charitable expenditure that can be counted toward the charity's disbursement quota
 - The charity would have to monitor the timing of when the agent expended funds on behalf of the charity in relation to calculating its 3.5% disbursement quota, if applicable

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2) Joint venture participant

- A charity can also carry on its activities jointly with other organizations or individuals through a joint venture relationship where the participants pool their resources in order to accomplish their goal in accordance with the terms of a joint venture agreement
- The charity is not relying entirely on the joint venture participant to carry out activities for the charity but instead does so on a pooled basis
- 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

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- Generally, a joint venture governing committee is required to establish, conduct and oversee the joint venture
- A charity must be able to show that its share of authority and responsibility over a joint venture allows it to dictate, and account for, how its resources are used
- e.g. Where the registered charity contributes 40% of the fundraising for the project, then the charity should have 40% of the voting rights on the governing committee
 - However, it needs to be recognized that the charity may be outvoted by the other joint venture participants and its resources used for purposes outside the agreement

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- Therefore, the agreement between the parties should include a provision that allows the charity to discontinue devoting its resources to the joint venture if its resources are to be used for purposes other than those that have been previously agreed upon
- Before entering into a joint venture agreement, a registered charity should ensure that it can carry out and comply with the terms of the agreement and actually do so in order to avoid the arrangement being viewed as a paper arrangement only

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3) Co-operative participants

- A "co-operative participant" is an organization that works side-by-side with a "registered charity" to complete a charitable activity
- The charity and the co-operative participants do not pool their resources and share responsibility for the project as a whole – each co-operative participant is responsible for only parts of the project
- e.g. a charity that provides care for the sick joins with a foreign organization that is not a qualified donee to build and operate a medical clinic in an isolated area
 - The charity agrees to provide qualified nursing staff at the clinic, but will not participate in other parts of the project, such as the construction of the building, buying medicine, etc.

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- 4) Contractors
 - A "contractor" is an organization or individual that a charity retains to provide goods and/or services
 - Contractors can be organizations or individuals that do not need to be either qualified donees under the ITA or recognized charities in their own countries
 - e.g. a Canadian registered charity with charitable purposes may contract with organizations or individuals in different countries to conduct charitable activities there on its behalf
 - However, the registered charity must give specific instructions to its contractors
 - The charity must exercise direction and control over the contractor and monitor the use of its resources

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- There are several advantages in using a contractor
- Limitations in Liability:
 - The automatic vicarious liability that exists between a registered charity and its agent in an agency relationship does not generally exist with a contract for services
 - Any liability associated with the work being carried out by the third party contractor under the contract for service is limited to the said contractor and does not extend to the charity
 - However, a plaintiff may argue that the charity had exercised too much day-to-day control over the contractor's activities and therefore should be vicariously liable for the contractor's actions

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- Financial Statements
 - In a contract for service, the assets that are transferred to the third party organization in exchange for services are no longer the assets of the registered charity and therefore do not need to be reflected in its financial statements of the charity
 - This can often be important for presentation purposes for the charity
- Segregation of Funds
 - Unlike an agency relationship, there is no need to segregate funds into separate bank accounts by the contractor
 - However, the contractor still needs to be able to account for monies received and expended

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- Disbursement Quota
 - Once assets have been transferred to a third party contractor under a contract for service for goods or services that are an integral part of the registered charity's work, they are considered to have been expended for the purposes of the registered charity's 3.5% disbursement quota
 - For disbursement quota purposes, the time of payment of monies by a charity to the contractor under a contract for services would be the time of the expenditure and not when the contractor fulfills the terms of the contract
- Insurance
 - The absence of vicarious liability may make a contract of service more attractive to an insurer

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- Direction and Control of Resources
 - CRA requires registered charities to take all necessary measures to direct and control the use of its resources through an intermediary
 - Although not formally required under the Guidance, CRA recommends that charities should have a written agreement in place with any intermediaries that they work with
 - Exception: If the money spent on a one-time activity is \$1,000 or less
 - Other forms of communication may be used to show direction and control, but a written agreement provides the best evidence

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- CRA recommends that the following measures be adopted to direct and control the use of a charity's resources
 - Create a written agreement and implement its terms
 - A clear, complete, and detailed description of activities is communicated to the intermediary
 - Monitor and supervise the activity
 - Provide clear, complete, and detailed instructions to the intermediary on an ongoing basis
 - If an agency relationship exists, segregate funds and maintain separate books and records
 - Periodic transfer of resources based on performance
- Charities must maintain a record of steps taken to direct and control the use of its resources, as well as detailed books and records (in French or English)

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C. HOW TO CARRY OUT A "PRE-AUDIT" COMPLIANCE REVIEW IF YOUR CHARITY IS CARRYING OUT FOREIGN ACTIVITIES

1. Preliminary Comments

- If your charity is engaged in activities outside of Canada using intermediaries, the question is not if you will be audited by CRA but rather when
- Therefore for charities in this situation, it is recommended that they carry out their own "pre-audit" of their foreign activities to determine if there has been compliance with CRA requirements and whether they can evidence the same to CRA

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- Purpose of 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

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- While CRA can audit any fiscal year of a charity, they generally will focus their audit some time within the last five (5) years of a charity's operations
- Therefore, these years should be the focus of a pre-audit, starting with the earliest financial year and working forward
- Such a pre-audit can be done by the charity itself, but involvement by its own legal counsel is highly recommended in order to establish solicitor-client privilege pertaining to the results of the pre-audit
 - The pre-audit should include retaining an accountant so that the work of the accountant will also be protected as privileged information between a solicitor and his or her client

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2. Identification of Foreign Activities/Projects Engaged in by the Charity

- Need to set out parameters of the review within the last five years
- Start the process by undertaking careful review of the charity's annual general ledger for years in question
- In reviewing the general ledger, need to identify each and every transaction which involved transfer of charitable property (cash or gifts in kind) to a non-qualified donee

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- These identified transactions should be copied and pasted into a separate excel spreadsheet (to be done by each financial year) for easier reference
- With each transaction found, then the charity needs to preliminarily identify the following:
 - Who the non-qualified donee recipient of the charity's property is;
 - Nature of the relationship with the non-qualified donee, e.g. agency, contract for services;

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- Whether the non-qualified donee recipient has utilized another organization to do the project in question, e.g. sub-agent or sub-contractor;
- 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;

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- Nature of charitable property transferred; and
- What, if any, written documentation re the transfer is immediately accessible
- Was the name of the non-qualified donee listed in T3010 of the charity and was it necessary to protect the name of the intermediary
- Need to prepare a summary memo identifying the transactions of potential concern, grouping them together as necessary and preliminarily identifying issues to be reviewed further with legal counsel (and the accountant)

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3. Determination if Charity's Foreign Activities Have Been in Compliance with CRA Requirements

- Once all transactions involving non-qualified donees have been identified, together with preliminary info regarding the transactions, then need to focus on gathering together all documentation showing "direction and control" by the charity over the project/activity in question
- Normally this involves the creation of project folders for each foreign activity/project undertaken by the charity

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- Once created and completed, each project folder can be numbered and then cross-referenced to the applicable transactions on the charity's general ledger
- This will facilitate easy access to the applicable project folder in the event questions arise about a particular project (or transactions on the general ledger) during a CRA audit
- In each project folder, a compliance checklist of all the steps/documentation required by CRA should be attached to the inside cover

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- Such a compliance checklist should include the following:
 - Date pre-audit started and completed for the project
 - Assigned project program number
 - Project type
 - Name of contractor
 - Name of sub-contractor, if applicable
 - Project name
 - Total funds transferred, together with interim fund transfers, if applicable, including amounts and dates

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- Required documents – indicate if 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 designation(s) for contractor/agent (for initial and any interim fund transfers)
 - Wire transfer and letter
 - Any sub-agreement, if applicable

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- 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 project took place

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- Any correspondence between the charity and contractor showing charity's supervision of and involvement in the project
- On-site visit reports by charity's directors, staff and/or volunteers
- External auditor report of on-site visits
- Receipts/vouchers or audit letter in lieu of receipts/vouchers
- Additional notes, as required

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

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- Need to prepare progress reports and pre-audit compliance reviews with the board of directors of the charity
 - Point out deficiencies
 - The board of directors need to feel a sense of ownership in the process
 - The board needs to oversee compliance process

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4. Compile All Key Documents for Each Activity/Project

- Once the charity has identified the documentation required to be in place for a project and stored in the applicable project folder, steps then need to be taken to locate and gather together the said documentation
- This will first involve a careful review of the charity's own records, e.g. minute books, past correspondence, e-mail searches, etc.
- Once all of the documentation in the charity's own records have been obtained, steps will need to be taken to locate all of the missing documentation

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- This is likely a good point to meet with legal counsel to review the current state of the project folders and the next steps to be taken by the charity
- The next key step will involve contacting the non-qualified donee agent or contractor to explain the documents the charity is looking to obtain and following up to make sure that they are provided for inclusion in the project folder
- This exercise will likely result in the charity discovering that certain required documentation was never prepared and may now need to be rectified

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5. Engage in Remedial Steps, as Necessary

- Determining whether remedial steps are necessary and, if so, which ones to take, will depend on the charity's particular circumstances
- This issue should be carefully reviewed with the charity's legal counsel before remedial documents are prepared
- Possible remedial steps could include the following:
 - Preparation of confirming written agreement and/or sub-agreements by means of a memorandum of understanding
 - Needs to be dated at present but deemed effective as of the date in question
 - However, CRA generally is not accepting of "after the fact" documents but it can at least be a record of the bona fide intent of the parties

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- Preparation of confirming project designations and sub-project designations
- Preparation of confirming resolutions adopted by the charity's board of directors
- Preparation of any missing reports from contractors and/or subcontractors, or preparation of more fulsome reports if initial ones are unsatisfactory
- All after the fact documentation must clearly show current date of preparation but can relate back to an earlier effective date

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- Translation of reports, if not done to date, into English and/or French
- Obtaining of any supporting documents in relation to the project, e.g. photographs, news articles, on-site visit reports by charity representatives, project related correspondence to or from the charity, etc.
- Obtaining receipts/vouchers or an audit report in lieu thereof, e.g. where the country in question is a cash based economy and the production of receipts is not an option
- May want to consider the possibility of a voluntary disclosure to CRA in conjunction with legal counsel


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6. Follow-up Issues

- Creation of instruction manual and checklist for use by the charity in any future foreign activities
- Consideration of a change in written agreement used for foreign activities, e.g. switch from agency agreement to contract for services
- Streamline number of non-qualified donees that charity works with to carry out foreign activities, in order to reduce size of compliance requirements
- Review whether charity's work could be done through another Canadian registered charity, thereby eliminating or reducing its need to meet compliance requirements
- Always keep board of directors informed

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