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## CARTERS/FASKEN MARTINEAU HEALTHCARE PHILANTHROPY: CHECK-UP 2015

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### Preparing for and Surviving a Charity CRA Audit

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#### OVERVIEW

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- CRA AUDIT PROCESS
- PREPARING FOR A CRA AUDIT
- WHAT ISSUES CAN ARISE DURING AN AUDIT?
- CONCLUDING THOUGHTS



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## A. WHY SHOULD CHARITIES BE CONCERNED?

- Charities should be concerned because
  - Audits can result in serious consequences, including revocation in egregious cases
  - Where the audit results in intermediate sanctions or revocation, reputational damage may occur
  - Responding to an audit can be expensive
  - Directors, officers, and managers can be found to be “ineligible individuals” in serious situations (see below)
- It is therefore important to understand the audit process and exercise due diligence both when an audit is scheduled as well as before



## B. CRA AUDIT PROCESS

- Auditors examine a charity’s financial affairs, its legal obligations under the *Income Tax Act* (Act), and whether it operates for charitable purposes
- There were 845 audits in 2013/2014 fiscal year, excluding political activities audits; these resulted in
  - 112 requiring no action response
  - 514 education letters
  - 139 compliance agreements
  - 4 penalties
  - 36 Notices of Intentions to Revoke
  - 20 voluntary revocations
  - 6 annulments
  - 1 suspension
  - 1 re-registration/pre-registration review
- CRA’s political activities audit team is conducting an 60 political activities audits over 2012 to 2016



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- CRA normally takes an education-first approach
- CRA may send reminder letters to charities
- CRA conducts both office and field audits
  - Office audits are conducted in Ottawa, involve a complete review of the charity's file (including T3010s), and may require the charity to submit additional records if requested
  - Field audits are conducted at the charity's premises
    - CRA reviews all information that it has on file
    - The auditor will call the charity to set an appointment
    - The auditors examine primary records, such as the charity's ledgers, journals, and bank accounts
    - A representative of the charity will need to be present to meet with the CRA auditors



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- Prior to an audit occurring, charities will normally be requested to complete an audit questionnaire
- The audit questionnaire asks for information about
  - Charity's objectives and activities, e.g.
    - Describe the charity's objectives and/or mission
    - Provide a complete list of all of the organization's programs, services, and/or projects
  - Political activities, e.g.
    - Describe any involvement the charity has had with partisan or non-partisan political actions
  - Fundraising, e.g.
    - Describe the nature of the fundraising activities including their location and frequency

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- Organizational structure, e.g.
  - Provide a list of all directors/trustees, committees, etc.
- Official donation receipts, e.g.
  - Describe what control the organization has over its donation receipts
- Books and records, e.g.
  - Provide details of all bank accounts, including their purpose and who has signing authority
- The response provided to the audit questionnaire can be critical, as admission of non-compliance may be reflected in a Notice of Intention to Revoke
- Charities need to seek legal and accounting assistance in responding to questionnaire



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## 1. What Can Trigger an Audit?

- Audits are triggered for different reasons, including:
  - Random selection
  - Follow-up on a previous audit or compliance issue
  - Red flags from a T3010 filing
  - Public complaints or media attention
  - Involvement with an abusive tax shelter
  - CRA review of a segment of the charitable sector
  - Related audits and internal CRA referrals
  - Confirm that assets have been distributed after revocation to eligible donees (arm's length charities)
  - Help CRA understand the purposes and activities of an organization applying for charitable status

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## 2. CRA Audit Response

- CRA's audit response will detail audit findings and set out the factual and legal basis of any proposed compliance actions
- If no compliance concerns exist, CRA will send a letter confirming this and stating that the charity's status will not change
- Where concerns exist, the Charities Directorate can issue
  - Education letters
  - Administrative Fairness Letters (AFLs), which may
    - Propose compliance agreements
    - Impose intermediate sanctions (including penalties and suspensions)
    - Take steps to revoke or annul charitable status

- Education letters
  - Education letters are the most common result of an audit; in 2013/2014, 61% of audited charities received an education letter
  - Are primarily used for minor non-compliance issues
  - Do not adversely affect a charity's registration
  - Provide guidance to the charity so that it can take the required steps to become fully compliant
  - Usually require no additional response from the charity
- Note, however, that CRA is not required to adopt an education first approach, and can proceed to enforcement of compliance



- Administrative Fairness Letters
  - AFLs are issued when non-compliance is more serious and may propose compliance agreements, intermediate sanctions, revocation, or annulment
  - The charity has 30 days to provide a written response
  - It may be possible to seek an extension
  - It is important to respond to every allegation in an AFL
  - CRA will consider all representations and will then
    - Decide no compliance action is necessary
    - Propose a compliance agreement
    - Impose intermediate sanctions
    - Take steps to revoke or annul
- Failure to respond can result in penalties and/or revocation or annulment

- Compliance Agreements
  - Are issued if non-compliance is serious but does not warrant revocation or annulment
  - Sets out the non-compliance issues, necessary remedial actions, and a timeline for changes
  - Are negotiated, signed, and dated by representatives of both the charity and CRA
    - Negotiation is key so that the terms of the agreement reflect the charity's side of the story
  - Can appear benign, but are problematic because, once signed, the charity is agreeing with CRA's allegations of non-compliance
  - Compliance Agreements are not binding on CRA



- Intermediate Sanctions
  - Are used in more serious cases of non-compliance and impose financial penalties and suspensions
  - Financial penalties can include penalties, such as
    - 125% on the eligible amount of any gift falsely reported on a receipt
    - 105% on the amount of any undue benefit provided
  - Suspensions of tax-receipting privileges can result from failing to
    - Keep proper books and records
    - Provide complete and accurate T3010s
  - Penalties can be imposed in conjunction with compliance agreement, suspension, or revocation



- Revocation
  - Can occur if an audit determines that the charity ceased to comply with the Act, e.g. it failed to
    - Devote all of its resources to charitable purposes
    - Maintain adequate books and records
    - Maintain adequate direction and control
  - CRA will send a Notice of Intention to Revoke
  - After 30 days, CRA can publish the notice of revocation in the Canada Gazette as well as on its website
  - A revocation tax of 100% of a revoked charity's remaining assets is due one year after Notice of Intent to Revoke, unless the charity expends its assets on charitable activities or transfers those assets to an "eligible donee" (arm's length charity)

- Annulment
  - Is rare, occurring in only 0.7% of audits in 2013/2014
  - Occurs when original registration was granted in error or because the organization no longer qualifies as a registered charity due to a change in the law
  - Annulled charities are no longer exempt from income tax and cannot issue official donation receipts after the date of annulment
  - However, annulled charities are not subject to 100% revocation tax and can therefore keep their assets after annulment
  - Annulled registered charities may possibly continue to be exempt as non-profit organizations



### 3. Appeal Process

- A charity has a right to object to the following decisions
  - *Notice of Intention to Revoke*
  - *Notice of Annulment*
  - *Notice of Assessment* (financial penalties)
  - *Notice of Suspension* (tax-receipting privileges)
- If a charity receives one of these notices, it can file an objection with CRA's Appeals Branch
- An objection must be filed within 90 days
- The Appeals Branch reviews decisions made by the Charities Directorate





- If a charity disagrees with the Appeals Branch's decision, it has the right to appeal to either
  - Federal Court of Appeal (FCA) regarding notices that annul, refuse to register or revoke registration
    - An appeal must be filed within 30 days
    - In turn, can seek leave to appeal to the Supreme Court (SCC)
  - Tax Court of Canada regarding intermediate sanctions, including assessments of penalties or notices of suspension of tax-receipting privileges
    - An appeal must be filed within 90 days
    - In turn, can appeal to the FCA
    - A charity can then seek leave to appeal to the SCC

## C. PREPARING FOR A CRA AUDIT

### 1. Preliminary Matters in Communicating with CRA

- What follows is based on the presumption that an audit by CRA has been scheduled
- However if an audit has not been scheduled, charities should still practice due diligence and carry out the following steps as a self-audit process
- If an audit is called, it is important to work with the charity's lawyers and accountants early in the process
  - Do not wait until the audit is complete
  - Lawyers and accountants can help guide what information to disclose
  - Lawyers can help to establish solicitor-client privilege

- Section 231.1(1)(d) of the Act requires that any person on the premises during an audit must give “all reasonable assistance” to a CRA auditor
- Respond quickly and do not ignore CRA
- Choose carefully which employee or volunteer will represent the charity with CRA, as CRA will be taking notes of the responses provided
- Be cooperative, polite and professional with CRA, but do not provide more information than asked for
- Charities can informally request that CRA provide further information about the progress or specifics of the audit



## 2. Dealing with Privacy and Privilege Issues

- CRA is authorized to obtain information relevant to the administration and enforcement of the Act
- CRA may ask a charity to provide its communications, including all emails in its database
  - Charities should be cautious about their use of email, as they can help or hinder the charity’s side of the story during an audit
- CRA can also obtain personal information about employees and donors
  - CRA can require charities to disclose employees’ personal information without their consent
  - CRA can also request donor information



- CRA cannot view documents subject to legal privilege, such as solicitor-client privilege
  - Solicitor-client privilege protects advice received from a lawyer
  - It can be waived if the charity is not careful when sharing communications, such as sharing legal opinions with third-parties
- If an auditor requests a document that a charity suspects is privileged, the charity should place the document in a sealed package and retain the package until a judge provides an order about its status (ss.232(3.1))



### 3. Understanding the Charity's Obligations

- Because it is impossible to predict an audit's timing, it is important for charities to understand their obligations
- CRA does not expect or require perfection, but charities are expected to exercise due diligence
  - E.g., charities must keep general ledgers or other books of final entry for 6 years from the end of the last tax year to which they relate or, if the charity is revoked, for 2 years after revocation (ss. 230(4))
  - However, there may be circumstances where these records should be kept permanently, such as endowment agreements
- Charities should document any uncertainties they have and seek clarification from CRA, as well as their lawyers and accountants

## 4. Preparing Before an Audit

- Charities must keep up-to-date books and records, including documents and historical information
  - Ready access to clean books shows CRA that the charity is transparent and is exercising due diligence
  - This information should be organized so that it can
    - Tell the charity's compliance and financial history
    - Allow for logical and timely disclosure
- Document, at the outset of each project, which charitable purpose the project is furthering and how expenditures achieve those purposes

- If charities find areas of non-compliance, they should deal with them before an audit is scheduled and document all remedial steps
- Charities may also want to consider, upon advice of legal counsel, possible informal voluntary disclosure of any non-compliance that cannot be fixed before an audit starts
  - Contact CRA in writing with a complete and accurate description of the non-compliance
    - The duration and extent of the problem
    - The amount of resources involved
    - How the non-compliance arose
  - A charity can also contact CRA on a no-name basis through legal counsel



- The board of directors has an important role, it should
  - Approve all changes to charitable programs
  - Regularly review corporate objects or purposes
  - Review and then approve all T3010 annual returns along with financial statements
- Charities should exercise early due diligence by
  - Avoiding excessive salaries and fundraising costs
  - Ensuring appropriate contracts are in place when transferring funds outside of Canada
  - Keeping copies of all gift receipts issued, payroll accounts, and bank statements
  - Drafting and retaining minutes of all board, members, and committee meetings
- Do a review of the charity's website and it's links

- Charities should be prepared to produce and make adequate copies of the following during an audit
  - T3010s and financial statements
  - Books and records (general ledger, cash receipt/disbursement journals, working papers)
  - Listing of bank accounts and all bank records
  - Listing of all cash donation receipts with the receipt number, name of donor, and amount reconciled to the financial statements & bank deposits
  - Listing of all gift-in-kind donation receipts, including the receipt number, name of donor, description, fair market value of property, and eligible amount
  - Duplicates of all charitable receipts issued

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- Reconciliation and breakdown of reported expenditures
- All expense source documentation (contacts, invoices, receipts, statements, cancelled cheques)
- Details of the charity’s activities supported by brochures, pamphlets, publications, membership and fundraising correspondence, newsletters, etc.
- All governing documents, including letters patent/articles, and by-laws
- Updated minute book with minutes of meetings of directors, members and all committees
- Listing of directors and trustees, their positions, occupations, relationship to others, and details of any remuneration or other compensation received
- Payroll documentation (T4s)
- Agency agreements and/or contracts for services

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## D. WHAT ISSUES CAN ARISE DURING AN AUDIT?

### 1. Inadequate Books and Records

- Inadequate books and records is the most commonly cited finding during a CRA audit
- CRA’s threshold for adequate books and records is high, but CRA cannot be arbitrary in its expectations
- Registered charities must maintain all books and records at the address in Canada on file with CRA
  - Charities must contact CRA to change this address
  - Concern about cloud servers located outside of Canada
- A charity must exercise due care regarding the accuracy of the books, e.g. charities must maintain
  - Proper control in the recording of all deposits
  - Minutes of meetings

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- Books and records must enable CRA to determine if there are any grounds for revocation and should include
  - An accurate record of total revenue
  - Returned cheques to verify payments
  - Invoices that support all expenses and all payments must be supported by documentation
- Charities must ensure the information in their returns, schedules, and statements is factual and complete
  - Discrepancies will raise CRA concerns
- Charities must be consistent in fulfilling their reporting requirements, e.g. by using either a cash or an accrual method of accounting



## 2. Charitable Purposes are Broad and Vague

- A charity must be established with clear purposes that are recognized as charitable
- The wording of charitable purposes cannot be overly broad and vague
  - Broad objects occur when they are too expansive and do not express a direct or tangible charitable benefit
  - Vague purposes occur when they are ambiguous and can be interpreted in many different ways
- CRA may assist in modifying unacceptable purposes where other areas of non-compliance found in the audit are not serious



### 3. Gifts to Non-Qualified Donees

- Other than performing its own charitable activities, a charity can also gift to “qualified donees”
- Qualified donees include: other registered charities, RCAAAs, a municipality in Canada, the UN and its agents, prescribed universities, certain housing corporations, certain charitable organizations outside of Canada, and the federal and provincial governments
- Gifts to non-qualified donees can result in revocation
- Charities transferring resources to other entities must maintain direction and control



### 4. Failure to Adequately Direct and Control Activities

- Where a charity conducts activities through an intermediary, it must be in a position to establish that its activities are carried on by the charity itself
- Activities carried out by an agent or contractor must be done through an agreement, in order to evidence direction and control
  - The Charities must obtain receipts of expenditures in order to evidence ongoing control
- board of directors must exercise independent direction and control, without interference by an outside body



## 5. Operating an Unrelated Business

- Related business is permitted (not private foundations)
- Related businesses are run substantially (90%) by volunteers or are linked and subordinate to its purposes
- A business will be linked if it
  - Is a necessary concomitant of its charitable programs
  - Is an offshoot of a charitable program
  - Uses excess capacity within a charitable program
  - Sells items that promote the charity
- Business activities may not be sufficiently linked to the charity's purposes
- A charity participating in an unrelated business activity can be revoked

## 6. Political Activities

- In addition to its regular audit activities, CRA has been directed to increase audits of political activities
- Although the basic rules regarding political activities by charities have not significantly changed, charities which become involved in political activities will be more vulnerable to an audit
- Political activities undertaken by a registered charity will fall within one of three categories
  - a) Charitable activities (i.e. advocacy)
  - b) Political activities (limited to 10% of the resources of the charity)
  - c) Prohibited partisan activities
- Undertake political activities with great caution!



## 7. Alleged Terrorist Activities

- It is against Canadian public policy for a charity to directly or indirectly finance or otherwise support terrorist activities
- Bill C-51 will also criminalize advocating or promoting the commission of terrorist offences “in general”
- Charities must ensure compliance with best practice guidelines, including CRA’s Avoiding Terrorist Abuse Checklist, and other international guidelines
  - Financial Action Task Force
  - US Department of the Treasury
  - Charity Commission for England and Wales
- The onus is on the charity to prove that it is not involved directly or indirectly in terrorist activities

## 8. Private Benefits

- Private benefit is only acceptable if it is minor and incidental to a charity’s purpose
- This means that any private benefit must be necessary, reasonable and proportionate to the resulting public benefit
- Examples of possible unreasonable private benefits
  - Payment of excessive salaries
  - Payment of excessive housing or other personal expenses
  - Promotion of books or videos where excessive profits accrue to religious leaders
- Reasonable and proportionate reimbursement for expenses incurred is permissible



## 9. Failure to File a T3010 or Filing Incorrectly

- This is a commonly cited compliance issue
- Charities must, within 6 months of the end of their fiscal periods, file a T3010 Information Return
- Examples of incorrect T3010 line items include
  - Understating total revenue and/or expenses
  - Under-reporting total gifts to qualified donees
  - Incorrectly reporting investment/interest income
  - Not reporting total compensation of employees
  - Inaccurately reporting taxable receipts
- Charities must complete all required schedules and/or worksheets associated with the T3010

## 10. Improperly Issuing Donation Receipts

- Regulation 3501 sets out the required contents of official receipts, e.g.
  - Name and Internet website of CRA
  - The description and amount of any advantage
  - Name and address of the donor
  - Content varies depending on whether the receipt is for a gift of cash or a gift in kind
- Receipts should not be issued for donated services or where the fair market value (FMV) of a gift in kind or an “advantage” cannot be determined
- The onus is on the charity to show the FMV is accurate and has been properly determined

## 11. Involvement with Ineligible Individuals

- The ineligible individuals provisions came into force on January 1, 2012
- CRA can refuse to register, suspend receipting privileges, or revoke registration if an ineligible individual is on the board or part of senior management or is in a position to control or manage the charity
- CRA began to enforce these provisions in summer 2014
  - It has revoked the registration of two charities in part because a director was previously a director of a charity when it was engaged in conduct that constituted a serious breach of the Act and was revoked
- More details see CG-024, *Ineligible Individuals*

## 12. Improper Investments

- A charity can and should invest surplus funds or assets to generate additional revenue for its charitable purposes
- The *Trustee Act* (Ontario) sets out the basis of the “prudent investor” standard that applies to investments by charities
- CRA has questioned high risk investments of charitable resources as a breach of fiduciary duty
- It is questionable, though, whether CRA has the constitutional jurisdiction to do so, given provincial jurisdiction over charitable property



## E. CONCLUDING THOUGHTS

- The above overview has outlined important steps for a charity may want to consider if an audit is scheduled
- Additionally, charities and their professional advisors can reduce future CRA challenges by following these suggested steps before an audit is scheduled and exercising early due diligence
- If non-compliance issues come to a charity's attention before an audit is scheduled and cannot be remedied, the charity should speak with legal counsel and consider the possibility of an informal voluntary disclosure

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