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The Ottawa Region 2017 *Charity & Not-for-Profit Law Seminar*


Ottawa – February 16, 2017

ALLOCATION ISSUES AND CRA: THE IMPORTANCE OF GETTING IT RIGHT

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A. CATEGORIZATION OF EXPENSES

- A charity is required to devote all of its resources to charitable activities – i.e., expenses on charitable activities must constitute the majority of the expenses and all other types of expenses must be on an ancillary basis
- T3010 requires each charity to report all expenses on lines 4800 to 4950, and then categorize them into the following categories
 - Charitable activities (line 5000)
 - Management and administration (line 5010)
 - Fundraising (line 5020)
 - Political (line 5030)
 - Others (line 5040)
 - Gifts to qualified donees (line 5050)

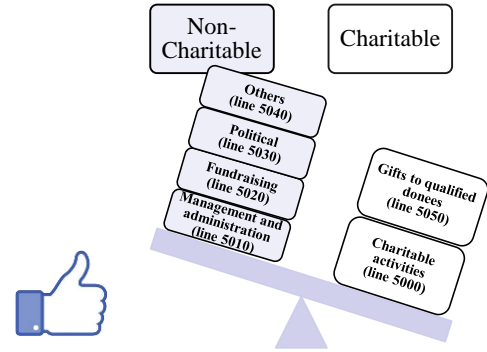
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- Lines 5000 and 5050 should constitute the majority of the expenses
- Where an expense is partly one type of expense and partly another type of expense, it would need to be allocated accordingly

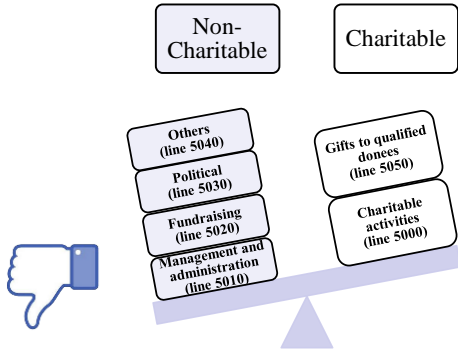
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B. IMPORTANCE OF CORRECT CATEGORIZATION AND ALLOCATION

- Ensures compliance with CRA's requirements on amount of resources a charity may spend on a certain type of activity
- Ensures T3010 is completed accurately
 - One of the basis for a charity to be selected for CRA audit
 - Most of the form is available to the public on CRA's website
- Affects calculation of fundraising ratio
- Affects calculation of whether disbursement quota is met
- Affects CRA's assessment of T2050
- Affects corporate governance/structure

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C. LACK OF CLEAR CRA GUIDANCE

- CRA does not have a clear policy or guidance on how charities are to allocate their expenses – only passing comments in a number of CRA publications

1. Guide T4033 how to complete T3010

- Only 2 brief references on pages 12 and 18
- Divide the expenditure between the applicable lines and expenditures must be allocated consistently and on a reasonable basis
- Gave examples of expenses for charitable, management /administrative, fundraising, or political activity, but no explanation or principles

<http://www.cra-arc.gc.ca/E/pub/tg/t4033/>

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2. Guide T4063 how to complete T2050

- Uses the term “prorate”
- Only 2 examples given on page 15, no explanation on principles
- E.g., Salary prorated based on time spent - an employee who has two duties:
 - manages the charitable activities of an organization (charitable)
 - does bookkeeping and maintains records (administration)

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- E.g., Occupancy costs (including all expenses associated with maintaining the building, such as, rent, insurance, heat, and electricity) prorated based on amount of space used - building used partly for two purposes:
 - a drop-in program for people with disabilities (charitable)
 - offices for the bookkeeper and administrative director (administrative)
 - director of corporate fundraising (fundraising)

<http://www.cra-arc.gc.ca/E/pub/tg/t4063/README.html>

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3. Fundraising Guidance – Appendix B

- CRA explains how to allocate expenses associated with a fundraising activity
- Very detailed explanation on how to “prorate the allocation” of costs – Useful for this to be set out in a standalone guidance since this is not just applicable to fundraising activities
- Where fundraising activities include content that is not related to fundraising, some of these costs may be allocated to charitable activities, management or administrative activities, or political activities
- Needs reasonable and consistent approach to allocating and reporting expenditures
- Onus is on the charity to explain and justify the allocation

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a) 100% allocation to fundraising

- Where 90% or more of the activity was devoted to fundraising, a charity will have to allocate all of the costs to fundraising
- To determine if an activity is exclusively (or almost exclusively) undertaken to fundraise, separate the fundraising content from the other content and assess proportions, resources devoted to and prominence given to charitable, fundraising, management or administrative, and political content
- Certain activities are by default considered to be 100% fundraising expenditures

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b) No allocation to fundraising

- Where an activity would have been undertaken without the fundraising component, then 100% of the costs will be allocated to the applicable expenditure (e.g. charitable, administrative, or political activity)
- Must meet “substantially all” test
 - If substantially all (90% or more) of the activity advances an objective (or objectives) other than fundraising, then no need to allocate anything to fundraising
 - When completing this test, a charity must separate fundraising content from other content

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- c) Prorated allocation of costs
- In some cases a charity may be able to prorate the allocation of costs of an activity between fundraising expenditures and charitable, management or administrative, and political activity expenditures
- But must be able to establish that less than 90% of the total content of the activity advances fundraising
- If more than 90%, then all expenditures must be allocated to fundraising
- To determine if prorating is possible, must separate the fundraising content from other content
- The onus is on the charity to produce the necessary accounting records to support the allocation

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- Guidance explains in considerable detail the characteristics associated with the different types of charitable, fundraising, management /administrative, or political content – more detailed than T4033 which only gave examples with no explanation
- Charitable content
 - Will directly further the charity's charitable purposes
 - Focuses primarily on beneficiaries or potential beneficiaries of the charity's programs, services, or facilities, not current or prospective donors
 - Is not, as a rule, prepared and/or delivered by individuals or organizations whose skills and usual responsibilities are to fundraise

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- Fundraising content
 - Implied or explicit requests for donations of cash or gifts in kind
 - Information about how to make a donation, including planned giving
 - The provision of goods and services that do not directly further the charity's charitable purpose
 - Activities, such as sports events, where participants are encouraged or expected to raise pledges
 - Advertising to promote events that involve fundraising
 - The management and administration of fundraising activities (e.g., planning and research for future fundraising)

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- Management and administrative content
 - Arranging, holding and reporting on board meetings
 - Bookkeeping, accounting, auditing, personnel, and other administrative services
 - Purchasing supplies and equipment and occupancy costs for administrative offices
 - Applying for grants or other types of government funding, and/or for gifts from other qualified donees
- Political content
 - An activity that directly or indirectly attempts to retain, change, or oppose a law in Canada or abroad, or sways public opinion on social issues
- Needs to maintain complete and detailed books and records – including records of research to determine appropriate costs

<http://www.cra-arc.gc.ca/chrts-gvng/chrts/plcy/cgd/ndrsng-eng.html>

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4. Political Activities Policy Statement

- Permitted political activities undertaken need to fall within expenditure limit (i.e., generally within the 10% resource limit)
- Where expenditures relate in part to political activities and in part to other activities, a reasonable allocation should be made and the methodology should be consistent from year to year
- If substantially all (90% or more) of an expense is for charitable activities, then the whole expense should be considered a charitable expense - if the expense relates substantially to a political activity, the whole expense should be counted as a political expense

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- Allocation of resources include financial, physical and human resources
- A charity needs to choose record-keeping methods suited to its operations provided that the method chosen is consistently applied, complies with the requirements of the *Income Tax Act*, and is sufficient to disclose its position

<http://www.cra-arc.gc.ca/chrts-gvng/chrts/plcy/cps/cps-022-eng.html>

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D. SUMMARY PRINCIPLES

- Onus on the charity to explain and justify the categorization and allocation is reasonable
- CRA requires “reasonable” allocation
 - Rationale of allocation clearly relates to the expense allocated and the activity allocated to, e.g.
 - Allocate salary based on time spent on duties
 - Allocate occupancy costs based on floor space used by each department, each function
 - Amount allocated is reasonable in relation to other costs and value of activities to the charity
- CRA requires “consistent” allocation
 - Similar expenses allocated in similar manner
 - Same allocation method consistently used and applied over time and across the board

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- Some principles from other tax cases (e.g. HST)
 - “Reasonable” means no specific formula must be used
 - As long as the allocation method used is a reasonable one, it does not need to be “more” reasonable than the one used by CRA or is the “best” method
 - Question is whether the (HST registrant’s) calculation is fair and reasonable, not that CRA has come up with a better calculation
 - Once the (HST registrant) has selected a method of calculation, the onus shifts to CRA to prove that the method in question is “not fair” or “not reasonable”
 - Method needs to be consistently used
 - If the method used was changed, there needs to be a basis why a change was made

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- If an activity is “substantially all” one type of activity, the entire expense would be allocated to that activity
- Allocation requires a clear understanding of what each type of activity means
- Keep it simple
- Keep detailed books and records to support the allocation
- Allocate up front – rather than at year end
- Need clear correlation between financial statements and T3010 allocation
- How best to allocate may differ depending on the circumstances, no one-size-fits-all methodology

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- Consider adopting policy on categorization and allocation
 - Helpful in complex situations
 - Ensures consistent implementation
 - Ensures correlation of reporting in books/records with T3010 reporting
 - Possible topics to include
 - Set out CRA’s requirements
 - Explain what each type of activity means (charitable, administration/management, etc.)
 - Principles used in allocating expenses
 - How each type of expense is allocated – allocation formula, factors, calculation, exceptions, etc.

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- Ensures the policy is in writing and implemented
- Periodic review of the policy and update as necessary
- Appoint a person or committee to review allocation issue

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FOOD FOR THOUGHT

- What are some basis to allocate staff salary?
 - Program staff
 - Admin staff
 - Fundraising staff
- How do you allocate occupancy costs for a wing of a building that is used for multiple purposes?
 - board meetings
 - program meetings
 - staff training
 - rented out on weekends

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- A charity publishes a booklet that is 30 pages long, 15 pages is an annual report with financials and 15 pages is on charitable programs of the charity. The charity spent 5 hrs on the annual report section but 50 hrs on the charitable section. How do you allocate the expenses used to publish the booklet?



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