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**TAX ISSUES ON THE WIND-UP OF
CHARITIES: BUDGET 2018
EXPANSION OF ELIGIBLE DONEES
AND BEYOND**

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Introduction

The life of a registered charity can come to an end for many reasons. In some cases, hardworking volunteers behind a registered charity may find themselves in a position where they've accomplished what they set out to do and there may no longer be a need for the particular purpose of the registered charity. In other cases, after support for a particular cause is drained, it falls upon the volunteers of a charity to bring its operations to an end. In more unfortunate circumstances, inadvertent or unintentional non-compliance with the *Income Tax Act* (Canada) ("ITA")¹ may have resulted in the sudden and unplanned loss of charitable status for a particular registered charity. In these cases, planned or unplanned, registered charities and their advisors will face complicated tax, employment, corporate, intellectual property, and other legal issues during the winding-up of a charity.

The focus of this paper is to provide an overview of federal income tax matters that can arise on the winding-up of a charity, and more specifically in relation to the application of the "revocation tax",² as discussed further below. In this regard, although the amount of the revocation tax assessed can vary depending upon the size of the charity that is subject to the revocation tax, Canada Revenue Agency ("CRA") assessed \$9.7 million in the 2015-16 period and \$6.2 million in revocation

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¹ *Income Tax Act*, RSC, 1985, c 1 (5h Supp) [ITA].

² ITA s 188(1.1).

taxes in the 2016-17 period.³ As a result, the monetary amounts that may be potentially assessed against a registered charity are not insignificant. This paper provides an overview of the revocation tax under the ITA, a brief discussion of corporate and common law issues related to the revocation tax, ways to reduce the revocation tax, and potential strategies to mitigate the revocation tax using multiple corporate structures.

Overview of Revocation Tax

What is the Revocation Tax?

Revocation tax applies on the loss of charitable status. An organization loses status as a registered charity if its charitable status is revoked by the CRA. This can occur through three different methods, which are described later in the paper

- voluntary revocation;
- revocation for failure to file the annual Form T3010; or
- revocation for cause, *e.g.*, as a result of an audit.

The reason for revocation of charitable status by CRA is published in Part I of the *Canada Gazette* and in the online list of revoked charities maintained on CRA's website.⁴ Upon a registered charity having its charitable status revoked, either as a result of voluntarily revocation or in the course of an audit, the charity has to pay a tax under Part V of the ITA.⁵ From this perspective, the charitable sector operates as a closed-circuit system. The purpose of this tax is to ensure that charitable property is applied to charitable use, *i.e.*, that it stays within the closed-circuit and continues to be used for charitable purposes.

The revocation tax under Part V of the ITA is equivalent to one hundred percent (100%) of the value of all remaining assets of the revoked charity after all debts and

³ David M. Sherman, *Practitioner's Income Tax Act*, 53rd ed (Toronto: Thomson Reuters, 2018) at 1288.

⁴ Canada Revenue Agency, "List of Charities" webpage, online: <https://www.canada.ca/en/revenue-agency/services/charities-giving/charities-listings.html>.

⁵ ITA s 188. See also Canada Revenue Agency, "Revocation tax and the T2046 tax return", online: <http://www.cra-arc.gc.ca/chrts-gvng/chrts/rvkng/t2046-eng.html>.

liabilities have been paid. Specifically, the revocation tax is calculated based upon the following formula:⁶

A – B

A	B
(a) the fair market value of a property of the charity at the end of that taxation year (which is deemed to have occurred on the date of CRA's notice of intention to revoke),	(a) a debt of the charity that is outstanding as of the date of CRA's notice of intention to revoke,
(b) the amount of an "appropriation", <i>i.e.</i> , property transferred to another person in the 120-day period before CRA's notice of intention to revoke, or	(b) an expenditure made by the charity during the winding-up period on charitable activities carried on by it, and
(c) the income of the charity during the winding-up period, <i>i.e.</i> , one year from the date of CRA's notice of intention to revoke, including gifts received by the charity in that period from any source.	(c) the FMV of any property transferred to an "eligible donee" during the one year period from the date of CRA's notice of intention to revoke, minus any consideration received by the charity for the transferred property.

In essence, the revocation tax requires that a revoked charity spend its money on its charitable programs or to donate its property to an "eligible donee" as discussed later in this paper.⁷ If the revoked charity does either or both with its remaining property, the revocation tax amount owing will be zero.

Filing Obligations Related to Revocation Tax

The revocation tax is determined by completing Form T2046, *Tax Return Where Registration of a Charity is Revoked*. The T2046 must be filed on or before the day that is one-year from the date on a Notice of Intention to Revoke issued by CRA ("NITR").⁸

⁶ ITA s 188(1.1).

⁷ ITA s 188(1.3). See below under "Payments made to an eligible donee".

⁸ ITA s 189(6.1).

Typically, an NITR is issued after an audit where CRA provides the revoked charity an opportunity to respond to its concerns that are raised in an administrative fairness letter. An NITR may also be issued where a charity has voluntarily asked CRA to revoke its status. If the T2046 tax return is not filed within this one year period (the “Winding-up Period”), CRA will estimate the revocation tax and issue the revoked charity a notice of assessment. The T2046 tax return covers the Winding-up Period, which can be shorter than one year if the return is completed earlier and submitted to CRA to be processed.

In addition to filing the T2046 tax return, the charity will normally be required to file two Form T3010, *Registered Charity Information Returns*. One T3010 will cover the same period as the T2046 tax return, and the other T3010 will cover the stub period between the time the last T3010 information return was filed and the start of the Winding-up Period.

It is important to make sure that the charity or its tax preparer attend to the filing of the T2046 and any related T3010s before the end of the Winding-up Period. Once the T2046 is received, if there are no errors or concerns related to the T2046, the form will be sent for processing.

If questions concerning the T2046 do arise, it is important to address them as soon as practicable. This is because CRA will sometimes exercise its discretion to carry out a Part V tax audit. Part V tax audits are rare, but do occur.⁹ In this regard, failure to complete the filing accurately or address any concerns raised by CRA may trigger a Part V tax audit. The purpose of a Part V tax audit is to verify the assets, liabilities, income, and expenditures after revocation of charitable status and to review transactions to ensure that the revoked charity has satisfied its Part V tax obligation. Although maintenance of the books and records of a registered charity after revocation is statutorily required, the possibility of a Part V tax audit is a good

⁹ See “The Audit Process for Charities”, Canada Revenue Agency, online at <https://www.canada.ca/en/revenue-agency/services/charities-giving/charities/compliance-audits/audit-process-charities.html>. For the 2013-2014 period, 2014-2015, and 2015-2016 periods there were 13, 14, and 25 “Other” audit outcomes. These statistics include both pre-registration audits and Part V tax audits.

reminder for a registered charity to keep its records in good order in the event that any transactions or transfer of property in the Winding-up Period are reviewed.

When is the Revocation Tax Payable?

Generally, the revocation tax is payable within the Winding-up Period. The Winding-Up Period ends on the latest of:

- the date the T2046 is filed, *i.e.*, no later than one year from the date of the NITR, but can also be earlier;
- the date that CRA issues a notice of assessment; or
- the date that CRA may proceed with collection enforcement if the charity has filed a notice of objection in respect of an assessment of Part V tax.¹⁰

While CRA generally will wait until the Winding-up Period has concluded before issuing an assessment, CRA is not precluded from issuing a notice of assessment earlier than the end of the one-year period from the date of the NITR. In this regard, CRA may assess “at any time” an amount that is owed under Part V.¹¹ This may occur, for example, where the assets subject to the revocation tax are being disbursed for the benefit of the directors or persons not at arm’s-length from the charity during the Winding-up Period.

In the event that CRA issues an assessment during the Winding-up Period, a charity will still have the opportunity to reduce the tax liability owing by virtue of subsection 189(6.2) of the ITA, through expenditures on charitable activities and transfers to eligible donees.

¹⁰ ITA s 225.1. See also Canada Revenue Agency, Summary Policy CPS-W03 “Winding-up period”, online: <https://www.canada.ca/en/revenue-agency/services/charities-giving/charities/policies-guidance/summary-policy-w03-winding-period.html>.

¹¹ ITA s 189(7).

Issues concerning Appeals, Objections and Collections

Determining the exact timing of the Winding-up Period and determination of the revocation tax may be complicated if a charity has objected to an NITR. Generally, where a charity files an objection with respect to an NITR, CRA will administratively extend the Winding-up Period to three months after all rights of appeal against the proposed revocation have been exercised or have expired. In addition, a charity may also file a notice of objection concerning an amount assessed against it under Part V of the ITA, or appeal such amount to the Tax Court of Canada.¹²

CRA is not permitted to commence collection action concerning the revocation tax during the Winding-up Period.¹³ This is the case even where an earlier assessment has occurred during the Winding-up Period.¹⁴ However, as with the discretion to assess Part V tax, CRA can obtain a court-order in circumstances where “a judge is satisfied that there are reasonable grounds to believe that the collection of all or any part of an amount assessed in respect of a taxpayer would be jeopardized by a delay in the collection of that amount”.¹⁵ Generally, there is no interest that accrues with respect to the revocation tax.¹⁶

Who is liable for the Revocation Tax?

Generally, the revocation tax is payable by the revoked charity. However, third-parties may also be exposed to liability for the revocation tax along with the charity in certain circumstances on a joint and several basis. In this regard, if a registered charity is planning to ask that its charitable status be voluntarily revoked, or is aware that an audit by CRA is likely to result in the issuance of an NITR, care must be taken during the period that is 120 days before the beginning of the Winding-up Period.

¹² ITA s 189(8).

¹³ ITA s 225.1(1.1). See also Canada Revenue Agency, Summary Policy CSP-C26 “Collection”, online: <https://www.canada.ca/en/revenue-agency/services/charities-giving/charities/policies-guidance/summary-policy-c26-collection.html>.

¹⁴ CRA Views, 2009-0332721I7 - Revocation tax (1 October 2009).

¹⁵ ITA s 225.2(2).

¹⁶ ITA s 189(8). See also *supra* n 14.

This is because the revocation tax takes into account all “appropriations” made during this period in accordance with the formula described on page 4.

An appropriation is a transfer of property to an individual or organization 120 days before the Winding-up Period, and is calculated based upon the FMV of the property transferred minus any consideration received for the property. If no consideration is received, the amount of the appropriation is simply the FMV of the property.

Individuals and other organizations are liable on a joint and several basis for the revocation tax related to appropriations.¹⁷ This liability is limited to the amount that the appropriated property exceeds any consideration paid for that property. Given that appropriations are included in the calculation of the revocation tax, if the registered charity is assessed revocation tax due to the appropriations made, but no longer has funds to satisfy the tax burden, the person that received the appropriation will be liable for that unpaid amount.

CRA recognizes that appropriations do not include gifts made to qualified donees¹⁸ in the period of 120 days before the Winding-up Period, or transfers of property

¹⁷ ITA s 188(2).

¹⁸ Subsection 149.1(1) of ITA provides that qualified donees are organizations that can issue official donation receipts for gifts that individuals and organizations make to them. The list of qualified donees consists of the following types of entities:

- (1) registered Canadian charities;
- (2) registered Canadian amateur athletic associations;
- (3) registered national arts service organizations;
- (4) registered tax-exempt housing organizations resident in Canada that are constituted exclusively to provide low-cost accommodation for the elderly under paragraph 149(1)(i) of the ITA;
- (5) registered Canadian municipalities;
- (6) Her Majesty in right of Canada or in right of a province;
- (7) the United Nations or its agencies;
- (8) registered universities outside of Canada the student body of which ordinarily includes students from Canada;
- (9) registered foreign charities outside Canada that have received a gift from the Government of Canada;
- (10) registered municipal or public bodies performing a function of government in Canada.

made in the course of delivering a charitable program, *e.g.*, scholarship amounts, medicines, school supplies, etc.¹⁹

Therefore, a registered charity considering disposing of property within the 120 days prior to the Winding-Up Period, if not in the course of its charitable activities or via gifts to qualified donees, should ensure that the property is sold at FMV and that there are records available to substantiate the value of the property, *e.g.*, an appraisal, etc. Alternatively, if the intent is to make a gift to a qualified donee during the 120-day period, then the charity or its advisors should confirm whether the organizations that receive transfers of property in the 120-day period are qualified donees.

Liability may also be assessed under the ITA with respect to tax liabilities for property transferred to non-arm's length persons. In this regard, persons who receive property from a registered charity may be liable for revocation tax where the charity was liable for an amount under the ITA the year property was transferred or in any preceding year where the property was transferred for less than FMV to a person not at arm's length from the charity.²⁰ Such amounts may include gifts, and a third-party may be liable for such amounts even if the charity has not yet been assessed by CRA.²¹ Therefore, while third-parties that receive transfers of property outside of the 120-day period before the Winding-up Period commences may not have exposure to liability under subsection 188(2) of the ITA, CRA has taken the position that subsection 160(1) could apply to transfers outside that 120-day period provided the conditions of that subsection are met.²²

Corporate and Common law issues related to revocation tax?

Given the application of the revocation tax, a charity that has involuntarily or voluntarily had its status as a registered charity revoked will effectively have no

¹⁹ Canada Revenue Agency, "RC4424 Completing the Tax Return Where Registration of a Charity is Revoked", online: https://www.canada.ca/en/revenue-agency/services/forms-publications/publications/rc4424/completing-tax-return-where-registration-a-charity-revoked.html#_Toc433374596.

²⁰ ITA s 160(1)(e).

²¹ CRA Views, 2011-0407081I7, "Third party liability for revocation tax" (27 September 2011).

²² CRA Views, 2010-0380651I7, "Third party provisions to collect revocation tax" (17 December 2010).

assets. Possibly, a charity that is no longer a registered charity and has satisfied the revocation tax could continue to operate as a non-profit organization (“NPO”), provided it meets the definition of an NPO under paragraph 149(1)(l) of the ITA. Practically speaking, however, absent any assets or future incentive for donors to provide funds to the revoked charity, this is generally not possible and therefore revocation of charitable status typically coincides with the winding-up of the operations of a charity, including dissolution if the charity is incorporated. As a consequence, there are various corporate and common law issues that may arise in the course of advising a charity on winding-up and meeting the revocation tax, as well as issues related to provincial land transfer tax.

Corporate and Provincial Trust issues

For the purposes of meeting the revocation tax requirements under the ITA, typically the remaining assets have either been given to a qualified donee before the date of the NITR, or to an eligible donee during the Winding-up Period. However, charities should also be mindful of meeting any corporate obligations within the applicable jurisdiction, or provincial common law requirements.

In practice, this means that charities should review the applicable dissolution clause contained in their governing documents, *e.g.*, the articles of incorporation, articles of continuance, letters patent, supplementary letters patent, or by-laws. Typically, these will require the transfer of the remaining property of a charity to other registered charities or qualified donees under the ITA. In some cases, though, the dissolution clause may contain:

- geographic restrictions, *e.g.*, that recipients of the property must be within the Province of Ontario or another province;
- restrictions that the recipient charity have “similar” charitable purposes or objects;

- restrictions that the recipient be limited to a particular designation of registered charity under the ITA, *e.g.*, “charitable organization”, “public foundation”, etc.; or
- the intended recipient of all remaining assets after payment of liabilities might be named, *e.g.*, the head body of a religious organization or the operating charity with respect to a parallel foundation.

In this regard, the dissolution clause should be reviewed if the charity is contemplating dissolving as a corporate entity after completing the transfer of assets to confirm that these restrictions are met in the course of ensuring that assets are transferred to a qualified donee or eligible donee prior to dissolution, even though the transfer is technically occurring before dissolution. For example, the recipient indicated in the dissolution clause might not be an eligible donee at the time of dissolution. As a further example, a potential recipient of funds from a registered charity that has lost charitable status may be an eligible donee for the purposes of the ITA, but may not have objects or purposes which are similar to those of the charity if required by the applicable dissolution clause.

Property of the registered charity that is purchased for FMV will not be considered an appropriation and therefore will be excluded from the calculation of the revocation tax. It should be noted that in the province of Ontario directors of the registered charity may be personally liable for breach of trust or other derogation of their fiduciary duties if the directors benefit by purchasing property from the charity below FMV.²³ In this regard, directors should not purchase the property of a charity

²³ *Faith Haven Bible Training Centre (Re)*, [1988] OJ No 969, 29 ETR 198 (Ont Surr Ct). A religious education school which was a registered charity ceased operations and its directors distributed the assets on winding up in part to themselves, despite a provision in the letters patent that directors were to receive no remuneration. The court found that the transfer of property and payments to directors was so egregious that the court held that, “these breaches of trust, particularly in their context of conflict of interest and duty, are so blatant (and therefore should have been so obvious in spite of legal counsel) that I could not conscientiously say that the conduct “ought fairly to be excused.” The court would have ordered the directors to repay to Faith Haven the monies wrongfully paid out with interest, but was prepared to approve the payments under a section of the *Trustee Act* given the time and effort the directors had put in over a nine year period to the charity.

in the course of dissolution in order to avoid being challenged on whether they are doing so at FMV, or are receiving other personal benefits, absent approval from the court or provincial regulator.²⁴

Lastly, the revocation tax, if not reduced by making a transfer to an eligible donee or other expenditures on charitable activities, would need to be paid to the Receiver General by cheque. However, in Ontario, the Office of the Public Guardian and Trustee in recent correspondence takes the position that such payments to the Government of Canada are not in furtherance of its charitable purposes, and could be considered a breach of trust. Therefore, if the charity is considering meeting the revocation tax by simply paying CRA, the charity or its advisors should confirm whether this is permitted within their provincial jurisdiction.

A registered charity that has lost charitable status because it has been dissolved as a corporate entity, either for lack of meeting corporate reporting requirements, or, for example, failing to continue to new legislation, and is subject to the revocation tax, may also have issues related to property that has been escheated to the Crown.

Issues Dealing with Real Property

A registered charity, in transferring property in order to meet revocation tax, will also need to take into account any provincial land transfer taxes related to real property that is to be transferred.

In this regard, while a revoked charity may transfer real property to an eligible donee by way of a gift, such gift may be subject to land transfer tax where there is an assumption of any liability, *e.g.*, a mortgage, which will be consideration for the purposes of calculating land transfer tax. Whether or not there is an exemption for land transfer tax for transfers that include the assumption of a mortgage would need to be reviewed within the particular jurisdiction in question.²⁵

²⁴ Ministry of the Attorney General, “Not-For-Profit Incorporator's Handbook”, online: https://www.attorneygeneral.jus.gov.on.ca/english/family/pgt/nfpinc/Not_for_Profit_Incorporators_Handbook_EN.html#_Toc435533089 at 6.6.2.

²⁵ For example, in Ontario under O Reg 386/10, to qualify for the charity exemption from land transfer tax, the following conditions must be met:

Reducing the Revocation Tax

A charity may reduce the amount of tax owing by using its remaining assets for its own charitable programs, or by transferring such assets to an eligible donee within the Winding-up Period.

In planning to avoid the revocation tax, two preliminary points should be made. The first is that revocation tax includes the value of any income or gifts that are received during the Winding-up Period. As such, while many registered charities may be aware that after losing charitable status, they might be able to continue providing services for which they charge a fee, or continue to fundraise provided that donors are aware that they will no longer be able to receive a tax receipt, such revenue can potentially add to the revocation tax owing.

The second point is that in planning to meet the revocation tax and any other requirements under the ITA, transfers made to an eligible donee are excluded for the purposes of meeting the disbursement quota obligations of the revoked charity.²⁶ However, the consequences of this exclusion in the context of calculating the Part V tax is not clear since the charity in question has already lost its charitable status

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- value of consideration must be nil, other than the assumption of any registered encumbrance
 - if a qualifying corporation, must have been the beneficial owner immediately prior to the transfer;
 - must have paid land transfer tax when it acquired the land;
 - must have held the land for a charitable purpose;
 - transferee must be a qualifying corporation and continue to hold the land for same charitable purpose for at least one year after date of transfer

See also Ontario Ministry of Finance, "Exemption for Certain Transfers of Land Between Registered Charities", online: https://www.fin.gov.on.ca/en/bulletins/ltr/2_2010.html. However, note that this exemption is generally only available for reorganizations, and therefore would not be of assistance to a revoked charity transferring property to an eligible donee which does not have the same purpose.

²⁶ ITA s 149.1(1.1)(c). Subsection 149.1(1) ITA provides that a registered charity is required to spend at least 3.5% of its assets that are not used in its administration or charitable activities – which basically means its investments assets. This is commonly called the "3.5% disbursement quota" or "3.5% DQ". The detailed rules for the 3.5% DQ calculation are set out in Income Tax Regulations 3701 and 3702. For an overview, see also CRA's webpage <http://www.cra-arc.gc.ca/chrts-gvng/chrts/prtng/spndng/clclb-eng.html>.

This section of the paper explores issues concerning the definition of eligible donee for the purposes of making transfer to them, together with alternatives for reducing the revocation tax by exercising due diligence in filing all T3010s and maintaining corporate status.

Payments made to an eligible donee

Prior to amendments made in the 2018 Federal Budget discussed below, an “eligible donee” for the purposes of the revocation tax was a registered charity, that:

- had more than half of its directors/trustees who are at arm’s length with each of the directors/trustees of the revoked charity;
- had filed all its annual information returns (Form T3010) with the CRA;
- was not subject to a suspension of its tax receipting privileges;
- had no unpaid liabilities under the ITA or the *Excise Tax Act*; and
- was not the subject of a certificate under the *Charities Registration (Security Information) Act*.²⁷

Changes made to the definition of eligible donee by the 2018 Federal Budget are outlined later in this paper.

Determining Eligible Donee Status

Rigorous due diligence should be carried out by a revoked charity to confirm that the recipient is in fact an eligible donee if transferring property to it during the Winding-up Period. Some of the criteria of the definition of eligible donee can be determined on a straightforward basis. For example, the requirement that a charity not be subject to a suspension order or that it not be subject to a certificate under the *Charities Registration (Security Information) Act* can be verified through review of CRA’s online charities listing. However, this is easier said than done for the remaining criteria, since many of the criteria of the eligible donee definition may be

²⁷ ITA s 188(1.3).

difficult to determine, both for the transferring revoked charity and the recipient eligible donee.

With respect to the requirement that more than half of the directors/trustees are at arm's length with each of the directors/trustees of the revoked charity, presumably, charities that have common directors would be familiar with the compositions of each board to determine whether or not the charities are dealing with one another at arm's-length. Publicly accessible records of the directors of registered charities are available. However, while registered charities that are corporations generally have their own corporate reporting requirements with respect to changes that occur on their board, in practice these records are often not up to date. Similarly, records concerning directors available through CRA are generally limited to the directors reported on the T3010 for a particular fiscal period, unless the charity has self-reported any changes to CRA concerning their board. As such, the revoked charity or its advisor should confirm the composition of the board of the recipient eligible donee through communicating with the eligible donee itself, and determining whether both CRA and other corporate regulators have been updated in this matter.

On the issue of whether or not the eligible donee itself has any unpaid liabilities, confirmation should be obtained from CRA, if possible. For example, what is the eligible donee status of a charity that has been assessed a penalty under section 188.1, but which is subject to a notice of objection? It's likely that only CRA would be able to advise on this issue.

Where property is given to an eligible donee, that recipient organization will be required to "certify" that it is an eligible donee at the time the property was transferred to it on the T2046. Specifically, the T2046 includes a Schedule 5 wherein the eligible donee is required to provide a description of the property transferred to it, the date of the transfer, together with any documentary proof related to the transfer. This will include, "cancelled cheques, proof of transfers of title to property, or other supporting document".²⁸ Generally, inclusion of assets that have been

²⁸ Canada Revenue Agency, "T2046, Tax Return Where Registration of a Charity is Revoked", online: <https://www.canada.ca/en/revenue-agency/services/forms-publications/forms/t2046.html>.

transferred in the financial statements of the recipient charity will not be sufficient for the purposes of a Part V tax audit, and source documents will need to be produced, *e.g.*, transfer documentation for title of motor vehicles, etc. Schedule 5 is to be completed multiple times in the case of the assets being transferred to more than one eligible donee. CRA's RC4424 guide concerning the completion of the T2046 states that the eligible donee is required to certify its own eligible donee status because "[t]he revoked charity may not be familiar enough with the internal affairs of the charity to which it proposes to transfer property to be able to certify that the charity is an eligible donee." Given the potential complexities involved, reliance on this certification alone may not be sufficient and the revoked charity should conduct and document further due diligence to verify eligible donee status in addition to the certification made on the T2046.

Expansion of Eligible Donees

At the present time, eligible donees are restricted to other registered charities. As such, other tax-exempt entities that are qualified donees but are not registered charities do not qualify for eligible donee status. The 2018 Federal Budget ("Budget 2018") proposed expanding the category of eligible donee to consider transfers of property made to municipalities by revoked charities as expenditures for the purposes of the revocation tax. Municipalities, however, will not automatically be eligible to be recipients of assets from registered charities that have had their status revoked, as the appendix to Budget 2018 stated that such transfers will be "subject to the approval of the Minister of National Revenue on a case-by-case basis."²⁹

On March 27, 2018, Bill C-74, *Budget Implementation Act, 2018, No. 1* ("Bill C-74")³⁰ was introduced and received first reading at the House of Commons. If passed, Bill C-74 implements certain measures proposed in Budget 2018, including amendments to subsection 188(1.3) ITA to add a new paragraph (b), which adds to the definition

²⁹ Department of Finance Canada, *Budget 2018: Equality + Growth / A Strong Middle Class*, (Ottawa: February 26, 2018), online: <https://www.budget.gc.ca/2018/docs/plan/budget-2018-en.pdf>.

³⁰ Bill C-74, *Budget Implementation Act, 2018, No. 1*, 1st Sess, 42nd Parl, 2018, (First Reading 27 March 2018).

of eligible donee, “a municipality in Canada that is approved by the Minister in respect of a transfer of property from the particular charity.” This change will apply to transfer of property made to municipalities as of February 26, 2018.³¹

The rationale provided in Budget 2018 for this expansion is that a revoked charity may have difficulty finding a recipient that qualifies as an eligible donee in, for example, a rural location, or where the assets have value to the community, such as a cemetery or a fire hall. This is certainly true of some situations wherein a registered charity may indeed be the only charity operating in a remote location, or where due to the small size of a community there is difficulty finding another registered charity that fits within the definition of qualified donee. At this time, it is not clear what criteria CRA will use when assessing whether a transfer to a municipality is permitted on a case-by-case basis. However, given the fact that the municipality carries none of the other criteria of an eligible donee, *i.e.*, that it be arm’s-length, not owe tax, etc., this may be an attractive option for future transfers in satisfaction of the revocation tax.

Bill C-74 also amends subsection 189(6.3) ITA concerning the reduction of liability for penalties, *e.g.*, incorrect receipts, unrelated business, etc., as opposed to the revocation tax. Currently, a reduction for liability for penalties can only be satisfied by payments made to other charities that are eligible donees, and Bill C-74 clarifies that this will not include transfers of property to municipalities where a charity has received a penalty as opposed to having been revoked by CRA.

Pursuing an Annulment

An alternative to revocation is an “annulment.” An annulment means that the registration of a charity is annulled as though it never existed. The grounds for an annulment are narrow. An annulment only occurs where registration was granted “in error” or if the charity no longer qualifies as a registered charity “solely” because of a change in the law.³² A charity that has been annulled is deemed never to have

³¹ *Ibid* at cl 30(2).

³² ITA s 149.1(23).

been registered as a charity, would no longer be exempt from income tax as a registered charity, and cannot issue official donation receipts. However, one benefit of an annulment is that an annulled charity is not subject to the revocation tax and does not have to file a T2046. As such, an annulled charity will be permitted to keep its assets.

Unfortunately, a registered charity cannot request that its status be annulled.³³ However, annulment may come up as an option in the course negotiations on an audit by CRA, or potentially when a charity has lost registered charity status due to the non-filing of the T3010 and is subsequently attempting to re-register. As such, an annulment is a limited option to mitigate the application of the revocation tax arising from an audit or in other encounters with CRA.

Planning for the Application of the Revocation Tax

The rigours of maintaining registered charity status are demanding, and therefore a charity may want to implement some strategies whereby if unintended non-compliance does occur, the assets of a registered charity can be preserved. As such, this portion of the paper explores practical steps for avoiding unintentional loss of charitable status, considerations for the application of the revocation tax on voluntary revocation, and additional steps to manage the potential application of the revocation tax by considering options in using multiple corporate structures.

Avoiding involuntary revocation for failure to file the T3010

One of the most common reasons that CRA revokes charitable status is for failure to file the annual T3010 return. For the 2015-2016 period, of 1,429 revocations that occurred, 708 were due to failures to file.³⁴ If a charity fails to file its Form T3010,

³³ Canada Revenue Agency, “Annulment of charitable registration”, online: <http://www.cra-arc.gc.ca/chrts-gvng/chrts/rvkng/nlmnt-eng.html>.

³⁴ Canada Revenue Agency, “Report on the Charities Program 2015-2016”, online: <https://www.canada.ca/en/revenue-agency/services/charities-giving/charities/about-charities-directorate/report-on-charities-program/report-on-charities-program-2015-2016.html#N106D5>

Registered Charity Information Return within six months of its fiscal year end, its charitable status could be revoked.³⁵

The failure to file the T3010 annual return is often the result of an inadvertent omission of the charity, such as failing to notify the CRA that the charity has changed contact information or changed personnel in the charity, *e.g.*, the election of a new volunteer treasurer who is unaware of the registered charity's filing obligations. The board of a charity can avoid failing to file the T3010 by having appropriate education for the board together with succession planning in terms of making sure that subsequent treasurers do not make the mistake of not filing the T3010 and not thinking that this will be an issue.

While CRA may revoke charitable status if the annual return is not filed within the statutory deadline, generally a graduated approach is taken. If the return has not been filed seven months after the end of the fiscal year end (*i.e.*, one month past the filing deadline), the CRA will send an NITR by registered mail.³⁶ The charity has 90 days from the date of the NITR to submit a notice of objection where warranted, *e.g.*, the charity filed the return but the return was lost in the mail. In the tenth month after the end of the charity's fiscal year end, the CRA will send the charity a Notice of Revocation of a Charity's Registration (T2051B) that states the effective date of revocation and a T2046.

Not only is it important that the T3010 be filed, but all additional documents that are required to be filed with the T3010 must also be filed on time, *i.e.*, the TF725, Registered Charity Basic Information Sheet, financial statements, and all schedules and worksheets where required. In addition, not only must the return be filed, CRA also takes the position that it must be accurately completed. In the *Opportunities for the Disabled Foundation v Minister of National Revenue*,³⁷ CRA took the position in revoking the registered status of the charity that the T3010 information return filed

³⁵ ITA s 168(1)(c).

³⁶ Canada Revenue Agency, "Revocation for failure to file", online: <http://www.cra-arc.gc.ca/chrts-gvng/chrts/rvkng/typs/flr-2-fl-eng.html>.

³⁷ 2016 FCA 94.

by it was inaccurate or incomplete and therefore it was as though the charity had never filed the return. The Federal Court of Appeal found that the inaccuracies were not “minor” as argued by the charity, and that simply filing an information return by the statutory deadline was not sufficient to comply with the requirement in the ITA that the return meets the requirements of the “Act and applicable regulations”. As such, care must be taken that not only is the T3010 filed within the statutory time frame, but that the return is both complete and accurate.

Addressing Revocation Tax on Re-applications from Failure to File

A charity that has lost status due to failure to file the T3010 cannot just file the overdue return to have status restored. The charity must submit a new application to be re-registered. The application must meet all current legislative and administrative requirements as though the charity was applying for charitable status for the first time. This may mean that the charity will need to amend its charitable purposes to encompass new activities it may have begun, or to meet modern drafting standards, and make other corporate changes if necessary, all of which take time and resources. As such, there is no certainty that charitable status will be restored.

Even if the applicant is successful on re-registering for charitable status, it must also pay a \$500 late-filing penalty and file all missing annual returns prior to re-registration. Organizations that have had their charitable registration revoked for more than four years cannot be re-registered.³⁸ Instead, their applications will be treated as a new applications for charitable status. Organizations that have had their charitable registration revoked for less than four years can apply to be re-registered. Moreover, a charity that has lost status for failure to file must still pay the revocation tax unless it:

- applies for and is re-registered within one year from the date the notice of intention to revoke registration was sent by the CRA;

³⁸ Canada Revenue Agency, “How to apply for re-registration”, online: <http://www.cra-arc.gc.ca/chrts-gvng/chrts/pplyng/r-rgstrtn/hw-r-rgstrtn-eng.html>; and “What an organization should know about re-registration”, online: <http://www.cra-arc.gc.ca/chrts-gvng/chrts/pplyng/r-rgstrtn/wht-r-rgstrtn-eng.html>.

- has paid all taxes, penalties, and interest that it owes under the ITA or the *Excise Tax Act* before the re-registration date; and
- has filed all missing information returns (Form T3010) and financial statements before the re-registration date.³⁹

Avoiding involuntary revocation for lack of governing documents

In addition to involuntary revocation occurring due to the inadvertent non-filing of the T3010, a registered charity may also have its status revoked due to loss of corporate status, or where the entity is an internal division that has registration by virtue of another incorporated charity that itself has lost charitable status.

Loss of corporate status can occur for various reasons, including failure to meet corporate reporting obligations, *e.g.*, non-filing of notices of change concerning directors or other annual returns, as a result of a court order or other corporate remedy, or in more extraordinary circumstances, such as having failed to continue from the *Canada Corporations Act* to the *Canada Not-for-profit Corporations Act*. As a consequence, CRA may revoke the charitable status of a charity that has lost corporate status as it would no longer meet the requirements of the ITA.⁴⁰ In this regard, a board of an incorporated registered charity should therefore ensure that it is exercising due diligence by:

- verifying that all corporate filings and registrations are up to date, *e.g.*, filing annual returns and other changes notices with Corporations Canada or provincial corporate regulator;
- ensuring that all statutorily mandated records are in good order, *e.g.*, minutes of meetings, registers of members, registers of directors, etc.
- if the corporation is not incorporated by general corporate statute, but by another statute, *e.g.*, *Agricultural and Horticultural Organizations Act (Ontario)*,

³⁹ *Ibid.*

⁴⁰ ITA s 168(b).

that all annual reports are filed so that the corporation remains in good standing.

In addition, there are also unincorporated registered charities that can have their charitable status revoked if they no longer meet the requirements of being a registered charity as a “a branch, section, parish, congregation or other division of an organization or foundation described in paragraph (a), that is resident in Canada and was either created or established in Canada and that receives donations on its own behalf”.⁴¹ In this regard, in the course of an audit, a charity that has been registered on the basis that it is a branch, section, parish, congregation or other division of a registered charity may be surprised to find that the charity they were affiliated with has been revoked, either voluntarily or involuntarily. As such, registered charities that are internal divisions of a larger charity should exercise due diligence by verifying on a regular basis that the registered charity of which they are an internal division of has kept its own registered charity status in good standing. This will assist the internal division charity in avoiding being involuntarily revoked as a result of no longer meeting the definition of “registered charity” under the ITA. On becoming aware of the revocation of the larger charity, the internal division should establish its own governing documents, e.g., by incorporating or otherwise formalizing its charitable purposes, and having those documents approved by CRA

Asking for Voluntary Revocation

In some instances, a registered charity may ask for voluntary revocation of charitable status because the charity has fulfilled its purpose or support for a particular cause is no longer strong enough for the charity to continue operating. In this situations, the registered charity may ask to voluntarily relinquish charitable status. Voluntary revocation is discretionary on the part of CRA.⁴² The following is an outline of the

⁴¹ ITA s 248(1)(b).

⁴² Canada Revenue Agency, “Voluntary Revocation”, online: <https://www.canada.ca/en/revenue-agency/services/charities-giving/charities/revoking-registered-status/types-revocation/voluntary-revocation.html>.

steps involved in relation to the voluntary revocation of charitable status of a registered charity.

- The registered charity must send a letter to CRA requesting the voluntary revocation of its charitable registration;
- Once CRA has received the letter, it will issue an NITR that states the proposed date of revocation. CRA will also send a Form T2046.
- The registered charity must complete the T2046 and file it with CRA within the Winding-up Period, together with all outstanding T3010s, and its T3010 for any stub period in that year up to the date of revocation.

At the time of writing this paper, the processing time for a voluntary revocation can be a lengthy period of time. In this regard, it may take upwards of a year for the voluntary revocation to be processed.

One benefit of voluntary revocation is that the registered charity can appropriately manage the application of the revocation tax prior to asking for voluntary revocation. In this regard, a registered charity can effectively dispose of all of its assets, taking into consideration the 120-day period prior to the NITR for appropriations, so that the revocation tax will be zero when voluntary revocation is requested. A further advantage is that during the Winding-up Period, a revoked charity is limited to making transfers to eligible donees in order to satisfy the revocation tax. In this regard, prior to applying for voluntary revocation, a registered charity can make gifts to qualified donees that do not need to fit the more limited criteria of eligible donees.

In addition, without the pressure of paying the revocation tax during the Winding-up Period, a registered charity may also address other issues, such as the orderly laying off of staff, if necessary, and the payment of severance. As these issues may take time in order for a charity to obtain employment law advice in relation to these matters, and any potential dispute concerning the amount of severance owed, completing these matters prior to asking for voluntary revocation reduces the risk

that the charity will be contesting these issues while also trying to reduce the revocation tax owing during the Winding-up Period. Certain assets, such as real property, may also take time to sell if they cannot be transferred to a qualified donee, or eligible donee if during the Winding-up Period, and disposing of such assets prior to voluntary revocation will remove them from the equation in relation to the revocation tax.

Given the length of time a voluntary revocation may take, however, there are some ongoing corporate and tax maintenance issues that need to be considered. For example, a charity will need to continue to ensure that all T3010s are filed while waiting to receive an NITR, notwithstanding that the charity has asked for voluntary revocation. In addition, if the charity requesting voluntary revocation is a corporation, it will need to consider keeping up regular corporate maintenance in the course of waiting for the voluntary revocation before applying for dissolution.

In practice, the NITR and the timing of applying for dissolution of the corporation may occur after a lengthy period of time. Financial review requirements related to the preparation of financial statements required under the applicable corporate statute will also need to be followed, together with the requirement that annual meetings and other aspects of corporate maintenance are completed. In this regard, on deciding to apply for voluntary revocation and, eventually dissolution, the board may consider reducing its size and as well as reducing the membership in the corporation so that these matters can be addressed expeditiously.

When it's Too Late

In some instances, the option of safely managing the revocation tax liability through due diligence or voluntary revocation is no longer available, and a registered charity has received an NITR. While a registered charity of course can pursue its appeal rights under the ITA in respect of an NITR, this is more often than not an uphill battle. Revocation for cause is rare. In the 2015-2016 period, out of 726 audits only 21

resulted in NITRs being issued.⁴³ Nonetheless, in these situations, it may be prudent for a registered charity to be prepared for this outcome. In this regard, this portion of the paper looks at options in using multiple corporations to help manage the impact of the revocation tax.

Not having all your eggs in one basket

A registered charity may consider operating through multiple corporations for various reasons, *e.g.*, to contain liabilities of high risk operations from the assets of the main operating charity or to control liability exposure between the main operating charity and its member organizations. A detailed review of multiple corporate structuring and relational models between multiple corporations is a topic for another paper.

In the event of the issuance of an NITR, all of the assets of a charity may become subject to the revocation tax. In some cases, a registered charity may have property that is valuable to its beneficiaries, *e.g.*, a school that is being operated by an educational charity or religious organization, various properties that a charity may have held title to for the beneficiaries of its programs, or funds that have been raised for a special purpose that cannot easily be fulfilled by another registered charity. In this situation, the volunteer board of directors or other members of the community may wish to keep these assets within the control of a similarly aligned group of charities.

In addition to these practical reason to utilise a multiple corporate structure, there is the added benefit that by separating various aspects of its charitable programs into multiple corporations, a registered charity will avoid all of its property being subject to the revocation tax if an audit results in an NITR and the charity is not successful in objecting to or appealing CRA's decision. Some examples of the use of a multiple corporate structure may include:

⁴³ Canada Revenue Agency, "The Audit Process for Charities", online: <https://www.canada.ca/en/revenue-agency/services/charities-giving/charities/compliance-audits/audit-process-charities.html>.

- Establishing a title-holding organization that is a registered charity for the purposes of holding real property for another registered charity;
- Establishing a parallel foundation for the purposes of holding special purpose funds raised for the operating charity;
- Establishing separate corporations that are registered charities for the operation of programs that have high compliance risks, *i.e.*, charities that provide funds to non-qualified donees outside Canada, charities that may run related business programs, etc.

Utilising a multiple corporate structure can also have a benefit of having entities that can act as available eligible donees in the off-chance that the charity under CRA audit was to have its registered charity status revoked. However, the definition of “eligible donee” would need to be carefully considered. In this regard, it is important that such charities would need to operate at arm’s-length from one another. If all the directors were the same as between multiple corporations that are registered charities, then if one was to be issued an NITR, the others will not meet the definition of eligible donee because the charities would not be at arm’s-length from one another. While changes to the composition of the board can occur in order to help the unrevoked charities meet the definition of eligible donee, depending upon the membership size of the organization, this option may not be practical if a large membership meeting needs to be orchestrated to elect new directors.

Building a New Boat while Taking on Water

In some instances, a charity’s registered status will be revoked and the option of re-application is not practically available. In those circumstances, a revoked charity may want to establish a new registered charity for the purpose of it operating as an eligible donee to receive the assets of the revoked charity. In our experience, CRA has sometimes suggested this approach to revoked charities, provided that the application of the new charity meets the requirements of the ITA.

The most difficult consideration in this scenario is the timing of the registration. As noted above, the Winding-up Period is generally one year, but can be longer depending upon the appeal process or the filing of a notice of objection. In some instances, however, CRA may exercise discretion to immediately proceed with revocation at the earliest opportunity regardless of whether or not the revoked charity has filed a notice of objection. In such cases, the Winding-up Period will be in strict conformity with the ITA.

An application for charitable status can take at a minimum 6 months before an initial response to the application is received from CRA, and in practice charitable status can take anywhere between 8 to 12 months to obtain. As a result, there is no certainty that a new legal entity can obtain registered charity status after an NITR has been issued, subject to any lengthening of the Winding-up Period that may occur as a result of an appeal or objection.

In addition, since an NITR has already been issued in this scenario, the new charity must be established and registered with a view to it meeting the definition of eligible donee, as only transfers to an eligible donee may satisfy the revocation tax once the Winding-up Period has commenced. In this regard, the directors/trustees of the new charity will need to be at arm's-length from those of the revoked charity. Given that the recipient charity created to be an eligible donee will be relatively "new", the other criteria of eligible donee would not typically apply, *e.g.*, that it have filed all T3010s or that it has no unpaid liabilities with CRA.

Conclusion

Challenging issues can arise related to meeting the revocation tax in relation to complying with common law or corporate obligations, reducing the exposure to revocation tax, and planning to mitigate the application of revocation tax. As such, prudent due diligence and planning are necessary in order to assist a charity in either not becoming subject to the revocation tax in the first place, or being able to effectively manage dealing with the revocation tax should it ever become payable. While not all registered charities or their professional advisors may go through a

situation where charitable status will be revoked, either on their own volition or through unfortunate circumstance, the application of the revocation tax can be a significant source of complexity and liability. However, by being pro-active, charities can be prepared for this eventuality.



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