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


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 <p>BARRISTERS SOLICITORS TRADEMARK AGENTS</p>	<p>Canadian Bar Association 2018 National Charity Law Symposium Friday, May 11, 2018</p>
<p>Tax Issues on the Wind-up of Charities: Budget 2018 Expansion of Eligible Donees and Beyond</p>	
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2	
<p>A. INTRODUCTION</p>	
<ul style="list-style-type: none">• The purpose of a registered charity can come to an end for many reasons• 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 presentation 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	
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B. OVERVIEW OF TOPICS

- The revocation tax under the *Income Tax Act* (Canada) (“ITA”)
- Corporate and common law issues related to revocation tax
- Ways to reduce revocation tax, and
- Potential strategies to mitigate the application of the revocation tax before revocation
- Potential strategies to mitigate the application of the revocation tax after revocation, i.e., when it’s too late

C. OVERVIEW OF REVOCATION TAX

- What is the Revocation Tax?
 - The revocation tax applies on loss of charitable status
 - An organization loses status as a registered charity if its charitable status is revoked by the CRA, e.g.,
 - voluntary revocation;
 - revocation for failure to file the annual Form T3010;
 - revocation for cause, e.g., as a result of an audit
 - Upon a registered charity having its charitable status revoked, the charity has to pay “revocation tax” under Part V of the ITA

5

- The revocation tax is equivalent to 100 percent of the value of all remaining assets of the revoked charity after all debts and liabilities have been paid, as calculated under section 188(1.1) ITA
- In essence, the revocation tax requires that a revoked charity spend its money on its charitable programs or donate its property to an “eligible donee”
- If the revoked charity does either or both of these with the remaining property, the tax amount owing will be zero

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6

- Filing Obligations Related to Revocation Tax
 - The charity must file a Form T2046, *Tax Return Where Registration of a Charity is Revoked* on or before the day that is one-year from the date on a Notice of Intention to Revoke issued by CRA (“NITR”)
 - This one year period is known as the “Winding-up Period”
 - The charity must also generally file Form T3010, *Registered Charity Information Returns* as required
 - Failure to complete the filing accurately or address any concerns raised by CRA may trigger a Part V tax audit

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- When is the Revocation Tax Payable?
 - Generally, the revocation tax is payable within the Winding-up Period, which 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

- 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
 - Where a charity files an objection with respect to an NITR, CRA will administratively extend the Winding-up Period to generally three months after all rights of appeal against the proposed revocation have been exercised or have expired
 - A charity may also file a notice of objection concerning an assessment under Part V of the ITA,
 - CRA is not permitted to commence collection action concerning the revocation tax during the Winding-up Period, except upon court order

- Who is liable for the Revocation Tax?
 - The revocation tax is generally payable by the revoked charity, but third-parties may also share liability for the revocation tax with the charity in certain circumstances on a joint and several basis
 - The revocation tax takes into account all “appropriations” (*i.e.* transfers of property not in the course of charitable activities or to a qualified donee, calculated as the FMV of the property minus any consideration received and made during the period that is 120 days before the beginning of the Winding-up Period)

D. CORPORATE AND COMMON LAW ISSUES

- A charity that is no longer a registered charity and has satisfied the revocation tax could continue to operate as a non-profit organization, provided it meets the definition in paragraph 149(1)(l) of the ITA
- Practically speaking, however, revocation of charitable status typically coincides with the winding-up of the 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 being able to meet the revocation tax

11

- 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, or common law requirements within the provincial jurisdiction
 - charities should review the applicable dissolution clause contained in their governing documents if the transfer of assets is occurring in conjunction with dissolution

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12

- Property of the registered charity that is transferred for FMV will not be considered an appropriation
- 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
- Payment of the revocation tax, in the opinion of the Office of the Public Guardian and Trustee, is not in furtherance of a charity's charitable purposes and could be considered a breach of trust
- A registered charity that has lost charitable status because it has been dissolved as a corporate entity may also have issues related to property that has been escheated to the Crown

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- 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 property taxes related to real property that is to be transferred
 - 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, unless the transferee qualifies for an exemption

E. REDUCING THE REVOCATION TAX

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

15

- Payments made to an eligible donee
 - Prior to amendments made in the 2018 Federal Budget, 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 receiving 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*

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16

- 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
 - 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
 - In the event of a Part V tax audit, the revoked charity will have to produce all documentary proof related to the transfer

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17

- Expansion of Eligible Donees
 - The 2018 Federal Budget (“Budget 2018”) proposed expanding the category of eligible donee to consider transfers of property made to municipalities 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, and 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”
 - 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

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18

- 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
- Bill C-74, *Budget Implementation Act, 2018, No. 1* (“Bill C-74”), introduced on March 27, 2018, implements certain measures proposed in Budget 2018, including an amendment to 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

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- Pursuing an Annulment
 - An alternative to revocation is an “annulment”, where the registration of a charity is annulled as though it never existed
 - 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
 - One benefit of an annulment is that an annulled charity is not subject to the revocation tax, does not have to file a T2046 and will be permitted to keep its assets
 - Unfortunately, a registered charity cannot request that its status be annulled

F. PLANNING FOR THE REVOCATION TAX

- Avoiding involuntary revocation for failure to file the T3010 and all additional documents
 - For the 2015-2016 period, of 1,429 revocations that occurred, 708 were due to failures to file T3010s
 - While CRA may revoke charitable status if the annual return is not filed within the statutory deadline, generally a graduated approach is taken
 - Seven months after the end of the fiscal year end, CRA will send an NITR (charity has 90 days)
 - In the tenth month after the end of the charity’s fiscal year end, CRA will send a Notice of Revocation of a Charity’s Registration (T2051B) with the effective date of revocation and a T2046

- 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, and there is no certainty that charitable status will be restored
 - If successful, the Charity must pay a late-filing penalty and file all missing annual returns
 - Organizations that have had their charitable registration revoked for more than four years cannot be re-registered and the application will be treated as a new application for charitable status

- 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;
 - 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

- Avoiding involuntary revocation for lack of governing documents
 - A registered charity may 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
 - A board of an incorporated registered charity should ensure that it is exercising due diligence by:
 - verifying that all corporate filings and registrations are up to date
 - ensuring that all statutorily mandated records are in good order
 - incorporation by statute other than general

- Requesting Voluntary Revocation
 - In some instances, a registered charity may request 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
 - Voluntary revocation is discretionary on the part of CRA
 - Steps involved in relation to the voluntary revocation of charitable status
 - letter to CRA requesting the voluntary revocation
 - CRA will issue an NITR and send a Form T2046
 - Complete filings within the Winding-up Period

- 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
- 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
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- 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
- Given the length of time a voluntary revocation may take, there are also 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
 - Also consider regular corporate maintenance in the course of waiting for the voluntary revocation before applying for dissolution

G. WHEN IT'S TOO LATE

- In some instances, the option of safely managing the revocation tax liability through due diligence or voluntary revocation may no longer be available and a registered charity will have received an NITR
- Appeal rights under the ITA in respect of an NITR 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
- It may be prudent for a registered charity to have prepared for this outcome

- 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
 - In the event of the issuance of an NITR, all of the assets of a charity may become subject to the revocation tax

29

- Some examples of separate corporations for this purpose may include:
 - 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.

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30

- Building a New Boat while Taking on Water
 - In some instances, 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
 - The most difficult consideration in this scenario is the timing of the registration
 - 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 can take 8 to 12 months to be completed

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G. 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
- Prudent due diligence and planning are necessary in order to assist a charity in either not having to pay revocation tax at all, or being prepared to eliminate the revocation tax should it ever become payable
- The application of the revocation tax can be a significant source of liability. However, by being proactive, charities can be prepared for this eventuality

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