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The 24th Annual *Church & Charity Law*[™] Seminar


Toronto – November 9, 2017

DIRECTION AND CONTROL: WHAT IS IT AND HOW TO COMPLY?

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A. INTRODUCTION

- “Direction and control” is not a term in the *Income Tax Act* (ITA)
- “Direction and control” is CRA’s requirement as a result of how CRA interprets the ITA
- The onus is upon the charity to evidence that they have fully complied with CRA requirements

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- “Direction and control” occurs in three contexts in CRA’s policies
 - When a registered charity engages in activities with a non-qualified donee acting as an intermediary (regardless of whether the activities are inside or outside Canada)
 - When a registered charity engages in program-related investments (“PRIs”)
 - When a registered charity conducts its own programs through internal divisions, departments, chapters, etc.

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B. BASIS FOR “DIRECTION AND CONTROL” IN ITA

- ITA provides that a charity can only use its resources in two ways
 - a) Making gifts to qualified donees
 - See definition for QDs below
 - Does not involve direction and control
 - b) Conducting its own activities by one of two ways
 - By charity’s own staff and volunteers
 - Through third parties (“intermediaries”) – CRA’s guidance requires charity to exercise direction and control

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C. MAKING GIFTS TO QUALIFIED DONEES (QDs)

- “Qualified donee” is defined in the ITA
- QDs in Canada
 - Registered Canadian charities
 - Registered Canadian amateur athletic associations
 - Registered Canadian national arts service organizations
 - Listed housing corporations resident in Canada constituted exclusively to provide low-cost housing for the aged
 - Listed Canadian municipalities
 - Her Majesty in right of Canada or a province
 - Listed municipal or public bodies performing a function of government in Canada

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- QDs outside Canada - only 3 categories
 - Prescribed universities – universities outside Canada with student body that ordinarily includes students from Canada
 - Listed charitable organizations outside Canada to which Her Majesty in right of Canada has made a gift in past 24 months and pursue activities related to disaster relief or urgent humanitarian aid or in the national interest of Canada
 - 2015 federal budget expanded “charitable organizations” to include foundations
 - A rolling list
 - The United Nations and its agencies
 - E.g., UNCDF, ILO, IFC, UNICEF
 - CRA does not have a list

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- Cannot make gifts to non-QDs
- Examples of non-QDs (unless they meet one of 3 categories in previous slide)
 - US 501(c)(3) tax exempt organizations
 - UK charities
 - International NGOs
- Funds to QDs are “gifts” under the ITA
- Charities are not required to exercise “direction and control”
- Can make the gift by deed of gift - short document
- Can make gift by funding agreement - more detailed, sets out terms of gift, for due diligence and monitoring purposes, not a CRA requirement

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D. CONDUCTING OWN ACTIVITIES

- “Own activities” test = activities must be directly under the charity’s direction, control and supervision and for which it can account for any funds expended
- CRA recognizes two ways to meet this test
 - A charity sending its own staff and volunteers on the ground to conduct the activities
 - Through third parties - “intermediaries”
- The charity is actively involved in programs that are intended to achieve its charitable purposes (e.g. directly funding its own employees and/or volunteers in carrying out its programs)
- The charity cannot carry out its charitable purposes by simply giving monies or other resources to an other organization that is not a qualified donee

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E. CONTEXT #1 CHARITY USING NON-QD AS INTERMEDIARY TO CONDUCT ACTIVITIES

1. General Requirements

- CRA permits charities to make payments to and work with third parties (i.e. an “intermediary”) - a person or non-qualified donee that is separate from the charity and who the charity works with to carry out its activities
- Charity must exercise “direction and control” over the intermediary

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- Relevant CRA guidance:
 - CRA *Guidance on Canadian Registered Charities Carrying Out Activities Outside of Canada*, CG-002 is available at <http://www.cra-arc.gc.ca/chrts-qvng/chrts/plcy/cgd/tsd-cnd-eng.html>
 - CRA *Guidance Using An Intermediary to Carry Out a Charity’s Activities Within Canada* CG-004 <http://www.cra-arc.gc.ca/chrts-qvng/chrts/plcy/cgd/ntrmdry-eng.html?rss>
- See Carters Charity Law Bulletins #219, #259 and #307 at www.charitylaw.ca

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- Must comply with requirements in the Guidance
 - How to conduct activities outside/inside Canada through third parties
 - What to include in written agreements with third parties
 - How to maintain direction and control over third parties
 - What books and records to obtain from third parties
- Failure to comply may risk the charity paying a penalty of 105% on the amount of the gift to non-QDs, increased to 115% on repeat infractions, and losing charitable status
- If a charity engages in activities (especially outside of Canada) using intermediaries, the question is not if it will be audited by CRA but rather when

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- Activities funded are activities of the funding charity, not activities of the third party intermediaries (to meet “own activities” test)
 - A charity cannot fund third party to help their programs or operations
 - A charity must give funds to third party to conduct the charity programs on behalf of the charity - i.e., it is the charity’s own programs
- Guidance states that “When working through an intermediary, a charity must direct and control the use of its resources” = “direction and control” is key
- Third party intermediaries do not have to be QDs, can be non-QDs, such as international NGOs, for-profits, or individuals

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- Before working with an intermediary and throughout the course of the arrangement, the charity must investigate the status and activities of the intermediary to ensure
 - The intermediary has the capacity to carry out the charity's activity (e.g., personnel, experience)
 - There is a strong expectation the intermediary will use the charity's resources as directed by the charity
- Must also do appropriate due diligence of intermediary concerning anti-terrorism compliance issues, particularly when working in conflict areas

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- A charity cannot act as a "conduit" to funnel money to non-QDs
 - A conduit is an organization that accepts donations for which it typically issues tax-deductible receipts and then funnels the money, without maintaining direction and control to a non-QD
 - To avoid being a conduit, the charity must have demonstrable control over the use of its money
- Examples of amounts spent on charitable activities:
 - The costs of goods transferred to an intermediary to provide eligible beneficiaries with charitable relief
 - Payments for buying goods and services to provide eligible beneficiaries with charitable relief

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2. Four types of Intermediaries

- Four common types of intermediaries that can be used
 - Agents
 - Joint venture participants
 - Co-operative participants
 - Contractors
- CRA does not recommend using one type of intermediary over the other
- Regardless of which option is used
 - Must meet own activities test
 - Must maintain direction and control
 - Must have written agreement

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- 1) Agents
 - A charity can appoint an agent to act as the charity's representative to carry out specific tasks on behalf of the charity
 - The charity relies entirely on the agent to carry out its activities on its behalf
 - The common law principle that the acts of the agent are that of the principal does not automatically meet the own activities test unless the charity is in fact directing what the agent does
 - A charity may have one general agency agreement that covers most of the terms in a relationship with its intermediary and additional directions that are specific for each particular activity

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- Liability concerns - Actions of the agent are deemed to be the actions of the principal, therefore the principal is vicariously responsible for the actions of the agent, could include civil and criminal liabilities
- Insurance concerns - Some insurers may be concerned about vicarious liability risks and not provide coverage
- Disbursement quota concerns - Until the agent spends funds from the charity, there is no charitable expenditure that can be counted toward the charity's disbursement quota

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- 2) Joint venture participants
 - A charity can carry on its activities jointly with other organizations or individuals through a joint venture relationship where the participants pool their resources to accomplish their goal in accordance with the terms of a joint venture agreement
 - The charity is not relying entirely on the joint venture participant to carry out activities for the charity but instead does so on a pooled basis
 - A charity can work with non-QDs as long as the charity exercises control over the activities proportionate to the resources it is providing and it can demonstrate this fact

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- Generally, a joint venture governing committee is required to establish, conduct and oversee the joint venture
- A charity must be able to show that its share of authority and responsibility over a joint venture allows it to dictate, and account for how its resources are used
- For example – If a charity contributes 40% of the funding for the project, then the charity should have 40% of the voting rights on the governing committee
- However, since the charity may be outvoted, the agreement needs to provide an exit strategy

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3) Co-operative participants

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

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4) Contractors

- A contractor is an organization or individual that a charity retains to provide goods and/or services through a contract for services
- The charity must give specific instructions to its contractors
- The charity must exercise direction and control over the contractor and monitor the use of its resources
- There are several advantages in using a contractor
 - Limitations in liability - No automatic vicarious liability, however plaintiff may argue that the charity had exercised too much day-to-day control over the contractor’s activities and therefore should be vicariously liable

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- Insurance – No vicarious liability may make a contract for service more attractive to an insurer
- Financial statements - Assets transferred to contractor in exchange for services are no longer the assets of the charity and therefore do not need to be reflected in the charity’s financial statements
- Segregation of funds – (Unlike agency) there is no need to segregate funds into separate bank accounts by the contractor, however contractor still needs to be able to account for monies received and expended
- Disbursement quota - Once assets are transferred to contractor to implement an activity for the charity, they are expended for the purposes of the charity’s 3.5% disbursement quota at the time of payment to the contractor

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3. Direction and control of resources

- CRA requires charities to take all necessary measures to direct and control the use of its resources through an intermediary
- Although not formally required under the Guidance, CRA recommends that charities should have a written agreement in place with any intermediaries that they work with
- Possible exceptions: If the money spent on a one-time activity is \$1,000 or less, charitable goods, or transfer to “head bodies” involving the lesser of \$5,000 or 5% of total expenditures
- Other forms of communication may be used to show direction and control, but a written agreement provides the best evidence

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

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- Monitor and supervise the activity - i.e., receiving timely and accurate reports to make sure that its resources are being used for its own activities – may involve the following
 - progress reports
 - receipts for expenses and financial statements
 - informal communication via telephone or email
 - photographs
 - audit reports
 - on-site inspections by the charity's staff
- CRA does not provide a black and white threshold or form to complete to evidence sufficient direction and control - what is sufficient depends on the facts in each case
- The larger the amount of funding, CRA would likely expect higher level of due diligence

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4. Need for detailed records and documents

- Charities must keep document trail to evidence due diligence and compliance with CRA requirements
- Upon CRA audit, CRA has right to access all books and records pertaining to the operations (not just financial records) – including written agreements, proposals, working papers, reports from intermediaries, emails, memos, committee meetings, records of phone meetings, website, publications, etc., as well as website, Facebook, publications of intermediaries
- Need to take care what is recorded in these documents
- Need to use the correct language in all documents
- Consider educating intermediaries on CRA rules in which the charity works and the language that should be used when communicating with the charity

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5. Transfers to head bodies outside Canada

- Many religious organizations and international organizations work with head bodies or umbrella organizations
- If the head bodies or umbrella organizations are located in Canada, they could likely be registered charities as well
- If the head bodies or umbrella organizations are located outside Canada, there may be issues for the local organization in Canada to send funds to the head bodies
- CRA's guidance states that having the head body act as an intermediary is *not practical* because the nature of the relationship may prevent the charity from *instructing* its head body in how to use the money

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- CRA warns that charities must still adhere to the same principles with respect to direction and control and cannot simply send gifts to the head body
- CRA recognizes that head bodies may provide charities with goods and services such as training, literature, policies and use of intellectual property
- Charities must make sure that they are "receiving goods and services equivalent in value to the amounts they are sending"
- CRA accepts that if the amount is small (lesser of \$5000 or 5% of the charity's annual total expenditures) no further evidence of benefit is required
- If the amount transferred exceeds the threshold amount, the charity must be sure that the goods and services received reflect the value of the funds transferred

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F. CONTEXT #2 CHARITY MAKING PRIs TO NON-QDs

- Charities can make "program-related investments" (PRIs) with QDs and non-QDs = an activity that directly furthers the investor charity's charitable purposes
- If PRIs are made to non-QDs, the charity must maintain direction and control over the program to achieve the charitable purpose – same requirement as the "own activity" test when conducting activities through intermediaries inside/outside Canada
- Must also show that any private benefit is incidental
- CRA Guidance CG-014, *Community Economic Development Activities and Charitable Registration*
<http://www.cra-arc.gc.ca/chrts-gvng/chrts/plcy/cgd/cmtycnmcdevpmt-eng.html>

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- Types of PRIs
 - Loans and loan guarantees - to another organization to allow it to achieve the charitable purpose of the investor charity, e.g., to acquire job training equipment for eligible beneficiaries
 - Leasing land and buildings - buying a building and leasing it to an organization to accomplish a charitable purpose, e.g., for education purposes
 - Share purchases - in a for-profit company to accomplish charitable purpose, e.g., operating an apartment complex for the poor – but there are restrictions for foundations

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- Charities conducting PRIs must have
 - A policy describing how the charity will make decisions regarding PRIs
 - Documentation explaining how each PRI furthers its charitable purpose
 - Exit mechanisms to withdraw from a PRI or convert it to a regular investment if it no longer meets the charity's charitable purpose
 - Evidence of direction and control over PRIs to non-QDs
 - Must also meet all applicable trust, corporate and other legal and regulatory requirements
 - Must ensure that any private benefit is incidental

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**G. CONTEXT #3
CHARITY'S OWN INTERNAL ACTIVITIES**

- We have seen in recent CRA audits that CRA requires charities to demonstrate direction and control over its own programs and those conducted by its internal divisions (eg branches, sections, parishes, congregations, divisions or chapters) ("Internal Divisions")
- CRA's guidance refers to "direction and control" in contexts #1 and #2 where non-QDs are involved – but not in the context where a charity operates its own programs in context #3
- Only 3 brief references to this requirement in CRA's website, with no explanation or details on how to comply or what CRA requires and there is no reference or analogy to how direction and control is to be exercised where non-QDs are involved

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(1) CRA's *Basic Guidelines for Maintaining Charitable Registration* (checklist) (<https://www.canada.ca/en/revenue-agency/services/charities-giving/charities/checklists-charities/basic-guidelines.html>)

"A registered charity must maintain direction and control over its activities (whether carried out by the charity, or by an agent or contractor on its behalf) and must not engage in prohibited political activities or unrelated business activities."

(2) CRA's webpage *Charitable activities* (<https://www.canada.ca/en/revenue-agency/services/charities-giving/charities/operating-a-registered-charity/activities/charitable-activities.html>)

"It can carry on its own charitable activities. These activities are conducted under the charity's direction and control. Such activities may be carried out by the charity's employees or volunteers, or by its intermediaries (agents, contractors, or partners)."

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(3) New CRA Guidance *Head bodies and their internal divisions* (released September 2017) ("Head Body Guidance")

<https://www.canada.ca/en/revenue-agency/services/charities-giving/charities/policies-guidance/head-bodies-and-their-internal-divisions.html>

"Head body must ... appoint and control the board of the internal division, approve the budget of the internal division, exercise a measure of control over the activities of the internal division"

- Guidance explains how head bodies located in Canada and their Internal Divisions can be registered as charities
- Implies head bodies need to have some level of control over their Internal Divisions
- Level of "control" referred to in this guidance seems to be lower than audits we have seen

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- CRA stakeholder letter released on July 21, 2017, indicates that all Internal Divisions will be issued a new BN (9-digit business number) in order to facilitate electronic system at CRA (eg for e-filing)
 - Instead of the current system of Internal Divisions using 9-digit BN of its head body with different suffix for Internal Divisions
- Both the Head Body Guidance and the stakeholder letter indicate that Internal Divisions have some level of autonomy from their head bodies – e.g., Internal Divisions have their own charitable registration, own financials, own T3010 filings, etc. – which is different from what CRA requires on recent CRA audits we have seen

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- What CRA requires (from audits we have seen) (not from CRA's policies)
 - A charity must demonstrate how it exercises direction and control over its own programs
 - If an Internal Division carries on an activity that the charity cannot show there is central control (by the board or central management)
 - CRA may take the position that that Internal Division is acting independently and is a separate entity from the charity
 - Even though the Internal Division is not legally a separate entity
 - An oxymoron?

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- If CRA recognizes the Internal Division to be a separate entity (instead of being part of the charity), serious consequences could follow for the charity
 - The Internal Division is a non-QD
 - The charity allows its resources to be used by a non-QD
 - The charity does not maintain direction and control over the use of its resources
 - The charity lends its charitable status for use by a non-QD in issuing donation receipts
 - The charity makes gifts to a non-QD
 - The charity confers undue benefit to a non-QD
 - ... and the list goes on –
- Which may result in the charity being subject to penalties, sanctions or revocation

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- Examples of evidence that CRA is looking for (from audits we have seen)
 - Whether the Internal Division is located separately from the main location of the charity
 - Whether the Internal Division has authority to hire its staff or engage volunteers
 - Whether the Internal Division has its own website
 - Whether the Internal Division conducts fundraising separate from that of the charity
 - Whether the Internal Division maintains its own books, records, financials, etc.
 - Whether the board of the charity actively participates in the programs of the Internal Division

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- Whether the Internal Division is overseen by a committee or group that does not actively engage the participation of the board
- Whether the charity is named or referred to prominently in the activities, programs, website, publications, Facebook, etc. of the Internal Division
- Whether the board actively instructs the Internal Division on what to do, monitors its activities, and is able to instruct the Internal Division what to do, or shut down the Internal Division
- Whether the Internal Division reports back to the board on its activities and whether the reports are subject to approval by the board

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- Lessons learned
 - The level of “direction and control” required on CRA audits seem to be more onerous than the requirements set out in the Head Body Guidance
 - Charities must ensure that the board is in control of all programs conducted by the charity
 - If a charity has Internal Divisions, it must ensure that there is central control of their operations
 - Allowing its Internal Divisions to have any degree of autonomous operations may be risky
 - If an Internal Division is intended to be autonomous, consider having the Internal Division set up as a separate charity
- It is hoped that CRA’s policies will be updated to clarify what CRA requires on this issue


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H. CONCLUSION

- Important for charities to evidence that they have fully complied with CRA requirements
- If a charity engages in activities by working through third party intermediaries (context #1 and #2), it needs to ensure that it exercise direction and control over the intermediaries as required in CRA’s guidance
- If a charity has operations involving branches, sections, parishes, congregations, divisions or chapters, etc., it must have control of those operations, or the operations out into a separate charity
- When in doubt, seek legal advice

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