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SECTION  
Webinar - March 4, 2021**

**CRITICAL ASPECTS OF  
FINANCIAL STATEMENTS AND  
T3010S THAT CHARITY LAWYERS  
NEED TO KNOW**

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 <p>BARRISTERS SOLICITORS TRADEMARK AGENTS</p>	<p><b>OBA CHARITY AND NOT-FOR-PROFIT LAW SECTION</b> <b>Webinar – March 4, 2021</b></p>				
<p><b>CRITICAL ASPECTS OF FINANCIAL STATEMENTS AND T3010s THAT CHARITY LAWYERS NEED TO KNOW</b></p> <p>By <b>Terrance S. Carter, B.A. LL.B., TEP, Trademark Agent</b> tcarter@carters.ca 1-877-942-0001</p>					
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<p><b>A. SETTING THE STAGE</b></p> <ul style="list-style-type: none"><li>• Both the Financial Statement and T3010 Information Return are key documents which describe, in detail, the annual operations of a registered charity</li><li>• Charity lawyers should be familiar with the basic elements of both Financial Statements and T3010s in order to be able to advise their clients when there are legal and compliance issues that have been improperly addressed and need to be corrected</li><li>• Since Financial Statements and T3010s are normally prepared by accountants, lawyers may feel reluctant to review and comment on them due to a concern that they are outside of their “wheel house”</li></ul> <p>www.carters.ca <span style="float: right;">www.charitylaw.ca</span></p>

- Charity lawyers, though, should not be deterred, as often there are aspects of both Financial Statements and T3010s that will need to be corrected or modified in order to ensure compliance with the Canada Revenue Agency (“CRA”) and other legal requirements
- Part of the difficulty lies in the fact that accountants prepare both Financial Statements and T3010s from the perspective of the accounting profession without necessarily taking into account the law that applies to charities
- This presentation highlights a select list of critical aspects of both Financial Statements and T3010s that charity lawyers can advise their clients on

## B. FINANCIAL STATEMENT CHALLENGES

### 1. When are Audited Financial Statements Required?

#### a) Canada Revenue Agency

- CRA does not require that registered charities have audited financial statements (“AFS”)
- However, the “books and records” requirement under section 230(2) of the *Income Tax Act* (“ITA”) means that a registered charity must have financial statements, whether they be audited or otherwise
- CRA recommends that there be AFS where the annual income of a charity exceeds \$250,000

## b) Corporate Requirements

- Section 96 of the *Ontario Corporations Act* (“OCA”) requires AFS to be prepared, save and except if its annual income is less than \$100,000 in a year and an extraordinary resolution of members (80%) authorizes an audit exemption (section 130.1(1))
- Sections 188 and 189 of the *Canada Not-for-profit Corporations Act* (“CNCA”) and section 76 of the yet to be proclaimed *Ontario Not-for-profit Corporations Act* (“ONCA”) requires AFS at different monetary thresholds
- Failure to comply can leave directors exposed to liability for not complying with the applicable corporate requirements (see s. 331 OCA; ss. 262(1) and (4) CNCA; and ss. 193(1) and (4) ONCA)

## 2. Independent Auditor’s Report

- The Independent Auditor’s Report in an AFS should normally provide an “unqualified opinion”
- However, where a Report has a “qualified opinion”, then it must be reviewed to see if it is “qualified” for matters other than the usual limitations involved with tracking donations to charities
- It is also important to:
  - Ask for and review any management letters from the auditor to see what issues may have been brought to the attention of management and the board of directors
  - Recognize that no communication from an auditor, including management letters, are privileged
    - If privilege is required, then the charity’s legal counsel should retain the auditor in order to have non-AFS information protected

### 3. Notes to Audited Financial Statements

- Notes to AFS are key to understanding the financial information set out therein, and are often the reason why most difficulties involving AFS are encountered
- Notes to the AFS contain key information identifying the charity, as well as restricted funds, investments and related party transactions, amongst others
- *E.g.* Note #1 to the AFS normally identifies:
  - Whether the organization is incorporated;
  - The statute it is incorporated under;
  - Whether it is a charity and what designation it has;
  - Its corporate name versus its operating name; and
  - Its purposes
- It is essential that errors in the description of the entity be identified and fixed, as the AFS should not become a source of unintentional public misinformation

### 4. Related Party Transactions

- Charities will often be involved in multi-party corporate structures for operating and/or risk containment
- What lawyers do not want to see in the AFS are statements suggesting that separate legal entities are operating as a single business or economic entity with a “close relationship”
- The concern is that such a description could be used as evidence in litigation to support a claim of vicarious liability between a charity and a purported “related party” as identified in the AFS
- This situation, though, is exactly what the AFS often provides for when complying with CPA Canada Handbook – Accounting: Accounting Standards for Not-for-Profit Organizations (“ASNPO”), section 4450

- Specifically, Section 4450 of the ASNPO states that:
  - Control of an entity is the “continuing power to determine its strategic operating, investing and financing policies without the cooperation of others.”,
  - Significant influence over an entity is “the ability to affect the strategic operating, investing and financing policies of the entity.”, and
  - Economic interest in another organization exists if:
    - “i. the other organization holds resources that must be used to produce revenue or provide services for the reporting organization; or
    - ii. the reporting organization is responsible for the liabilities of the other organization.”

- The ability of one entity to appoint the majority of the board of another entity would obviously constitute “control”
- However, it is less obvious how to apply the many other factors that make up the accounting notions of “significant influence” and “economic interest” as identified in the CPA Accounting Standards
- These factors are not necessarily sufficient to identify an organization as a related party, which then requires either “disclosure” of the relationship in the AFS or, even worse, that consolidated financial statements of the two organizations have to be prepared

- Charity lawyers may need to push back on such characterizations where necessary
- This is because by disclosing to users of the AFS “the breadth of the resources that the charity can benefit from” as well as “the risks”, the auditor may in fact be providing a road map for a litigator to argue that the charity is vicariously liable for the actions of another organization
- In addition, labelling a relationship with a foreign entity as being a “related party” could result in CRA taking the position that the Canadian charity may not be sufficiently independent for purposes of maintaining its status as a Canadian registered charity

## 5. Restricted Funds Issue

- ASNPO section 4410, *Contributions - Revenue Recognition*, does not distinguish between donations, grants or inter-charity transfers
- Instead all 3 terms are lumped under the “contributions” definition, *i.e.* being “non-reciprocal transfers”
- “Contributions” are then identified as being one of the following:
  - Restricted contributions, being contributions subject to externally imposed stipulations
  - Endowment contributions, being restricted contributions specifying that the resources contributed be maintained permanently
  - Unrestricted contributions, being contributions that are neither restricted or endowment contributions

- The challenge with this type of accounting classification is that it does not necessarily reflect trust law concepts and, therefore, has the potential for creating confusion and possibly even mismanagement of restricted funds
- Some examples of problems arising from possible mischaracterization of restricted funds in the AFS can include one or more of the following:
  - Making a determination that the fund is restricted or unrestricted without the auditor doing the necessary due diligence in reviewing all of the applicable facts and/or documentation
  - Failing to recognize the difference between an unenforceable precatory trust and an enforceable restricted charitable purpose trust

- Calling a fund an “endowment fund” with no corresponding ability to encroach on capital when the document creating the endowment may in fact include a right to encroach
- Defining “investment income” from an endowment fund as including capital gains for disbursement purposes when the gift agreement may not have provided for a “total return” definition of income, which is necessary to override the default trust law rule that capital gains is attributed to capital rather than being available to be expended as “income”



## 6. Commingling of Restricted Funds

- At common law, restricted funds held by a charity, such as endowments, must be kept in separate bank accounts from other restricted trust funds, as well as separate from the charity's general bank account
- However, Regulations under the *Charities Accounting Act* ("CAA") adopted in 2001 permit commingling of restricted charitable purpose trust funds if certain requirements are met, including:
  - Combining the funds must advance the administration and management of each fund
  - All gains/losses/income/expenses must be allocated ratably to each fund on a fair and reasonable basis and in accordance with GAAP
  - Specific records must be maintained under subsection 3(5) of the Regulations

- Regardless, a charity cannot commingle restricted charitable purpose trust funds with its general funds
- Such unauthorized commingling might occur where there are internally restricted endowments commingled with externally restricted endowments for investment purposes, together with income earnings from both
- This is often reflected in AFS which lump both externally restricted and internally restricted endowments together
- Commingling restricted charitable purpose trust funds in contravention of the Regulations in the CAA could expose the directors to allegations of breach of trust
- AFS do not always show compliance with Regulations under the CAA and many accountants may not be aware of the Regulations

## C. T3010 INFORMATION RETURNS: TIPS & TRAPS

### 1. Correctly Completing the T3010 is Essential

- Incorrect or misleading information in a T3010 Information Return can result in the suspension of receipting privileges and/or imposition of penalties for the charity
- In addition, an incorrect T3010 can seriously impact the reputation of the charity with donors, sponsors, members, supporters, as well as the general public
- It is therefore essential that there be a careful review of the T3010 by the board of directors before the T3010 is filed
- The board needs to authorize a “person who has authority to sign for the charity” in order to certify the information in the T3010 is “to the best of my knowledge correct, complete and current”
- Charities may want to consider having legal counsel review the T3010 for correctness, including the following issues

### 2. Section A : Identification

- a) A1 (Line 1510) Subordinate Position: “Was the charity in a subordinate position to a head body (or parent organization referenced in CRA Guidance T4033)?”
- CRA Guidance
    - Says “select yes” if charity is an internal branch, section or division of another registered charity or “has its own governing documents and its activities are determined by another organization”
  - Potential Traps
    - Terms “subordinate position” and “parent organization” are unclear
    - Question assumes “parent” is a registered charity, which may not be the case if it is a foreign entity
    - Unclear what happens if the parent organization does not agree that it is in a dominant position

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– Tips to Avoid Traps

- If separately incorporated with own registered number, answer “no” to this question even if affiliated with a larger charity
- CRA-approved “associated charity” status with another charity is not “subordination” for the purposes of this question
- If the charity is an internal branch, section or division, then it may want to consider becoming separately incorporated for liability reasons

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**3. Section C: Programs and General Information**

a) C4 (Line 2100) Foreign Activities: “Did the charity carry on, fund or provide any resources through employees, volunteers, agents, joint ventures, contractors or other individuals, intermediaries, entities, or means (other than qualified donees) for any activity/program outside of Canada?”

– CRA Guidance

- If yes, the charity must complete Schedule 2, “Activities Outside Canada”
- Line 200: Total expenditures for activities carried on outside Canada, excluding gifts to QDs
- Line 210: If any of the charity’s financial resources were used for activities outside Canada under any kind of an arrangement, select yes

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- Potential Traps
  - Line 2100 doesn't ask for same information about activities carried on inside Canada through third parties, *etc.*, although implications are the same, *i.e.* gifts to non-qualified donees are prohibited both inside and outside of Canada
- Tips to Avoid Traps
  - Answer yes to line 2100 if you transfer any monies to non-QDs outside of Canada
  - Review if charity can answer yes to Schedule 2 question #5 (Line 240 - employees) and question #6 (Line 250 - volunteers), as this can serve as evidence of "direction and control"
  - Disclosing the names of individuals or organizations who act as intermediaries could have security ramifications for the intermediaries

- b) C14 (Line 5820) Receipting for Another Organization:  
 "Did the charity issue any of its tax receipts for donations on behalf of another organization?"
- CRA Guidance
    - If the charity issued official donation receipts for another organization, select yes
  - **TRAP!**
    - Charities are not permitted to issue receipts on behalf of another and cannot allow another organization to use its registration number
  - Tips to Avoid Traps
    - Never allow the charity to become a conduit for another organization
    - If a charity must answer "yes" to this question, it should seek legal advice to consider strategy

## 4. Section D: Financial Information (Schedule 6)

### a) Disbursement Quota (Schedule 6)

- CRA Guidance
  - Lines 5900/5910: Enter the value of property not used in charitable activities or administration during the 24 months before/after fiscal period
- Potential Traps
  - The 3.5% disbursement quota (“DQ”) is calculated using Lines 5900 and 5901
  - If terms of an endowment agreement do not allow encroachment on the capital of the trust, foundations may find it difficult to meet the DQ when the foundation has insufficient income
  - In this situation, the charity may need to seek a relieving order under section 13 of CAA

- Tips to Avoid Traps
  - A charity has met its DQ if:
    - amount spent on charitable programs (Line 5000);
    - gifts made to QDs (Line 5050) minus any designated gifts; or
    - amount of an approved reduction (Line 5750) equals or exceeds the DQ spending requirement
  - Separate out charitable expenditures from management and administrative or fundraising expenditures
  - See CRA Guidance (CG-013) on Fundraising for tips on allocation of expenditures
  - Keep records of disbursement excesses or shortfalls from previous years
  - Use excess from five previous fiscal periods to address shortfall in current fiscal year or carry back from following year

b) Fundraising Ratio (Schedule 6)

– CRA Guidance

- Line 4500: Total eligible revenue for which the charity issued tax receipts, whether or not it relates to fundraising activity
- Line 4630: Total gross non-tax receipted revenue which was generated as direct result of fundraising
- Then total of lines 4500 and 4630 divided by line 5020 (total expenditure on fundraising)
- The end result will be the fundraising ratio

– Potential Traps

- If the fundraising ratio is above 35%, it could become cause for an audit by the CRA, and/or scrutiny by the general public

– Tips to Avoid Traps

- If ratio is over 35%, then see if any portion of line 4530 (non-receipted gifts) related to revenue from fundraising can be moved to Line 4630 to lower the fundraising ratio
- If ratio is over 35%, then see if sponsorship revenue can be included on Line 4630 in order to lower the fundraising ratio
- Be aware of the public nature of these amounts, as anyone can calculate your charity's fundraising ratio using the T3010, resulting in possible negative public commentary

## D. KEY TAKEAWAYS

- Charity lawyers have an important role to play in reviewing and advising their clients on AFS and T3010s
- Legal counsel need to be pro-active in explaining the importance and benefits of a legal review of key aspects of AFS and T3010s, as “the devil is in the details”
- A careful legal review can help protect the charity, as well as the board of directors in fulfilling their fiduciary duties

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