Editor’s Introduction: The New Regime for Charities

Recent developments in Canadian tax law reflect important legislative changes to Canada’s self-assessment income tax system. Among these developments are specific sanctions for deficient performance in the transfer-pricing area; specific sanctions that apply to third parties, including those whose advice or influence affects taxpayers’ compliance with the Income Tax Act; and administrative, legislative, and treaty developments in the international area to enable tax authorities to more comprehensively and systematically evaluate and enforce compliance with the tax rules. Another area that has been the subject of legislative changes to encourage more rigorous compliance with the Act is the charity tax regime. Legislation to reinforce the compliance rules applicable to charities was enacted in 2005. As with many compliance or reporting rules and the sanctions that accompany them, important substantive legal issues are necessarily raised, which, in light of new sanctions, take on added importance. As yet, however, there is little experience with the new regime to guide charities, and their advisers, on how the new rules will be applied.

In this issue of the journal, Robert Hayhoe and Marcus Owens anticipate the reach and application of the new Canadian charity tax sanctions with the benefit of reference to the United States’ experience with comparable rules. Louis Tassé, who is an experienced practitioner in this area, takes the Hayhoe and Owens’ comparative analysis into account in providing his comments on the practical implications of the Canadian rules. In areas such as this, a constructive and penetrating dialogue is a useful way to develop an understanding of the impact of important legislative changes in the tax area. As in the case of recent Policy Forum discussions, we invite others to engage in the exploration of the issues raised here by offering their own comments, perhaps in a subsequent forum or in correspondence addressed to the editors of this journal.

Scott Wilkie
Editor
Policy Forum: The New Regime for Charities—Further Reflection

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PRÉCIS
Dans ce numéro du Revue fiscale canadienne, Robert Hayhoe et Marcus Owens présentent une intéressante analyse comparative, d’un point de vue de la politique fiscale, du nouveau régime de conformité fiscale des organismes de bienfaisance au Canada et aux États-Unis. Ce bref article passe en revue certaines des considérations d’ordre pratique des nouvelles règles canadiennes.

ABSTRACT
In this issue of the Canadian Tax Journal, Robert Hayhoe and Marcus Owens provide an interesting comparative analysis, from a policy point of view, of Canada’s new charity tax compliance regime and the US regime. This brief article reviews some of the practical implications of the new Canadian rules.

KEYWORDS: CHARITIES ■ FOUNDATIONS ■ COMPLIANCE ■ PENALTIES ■ SANCTIONS ■ APPEALS

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BACKGROUND

As Robert Hayhoe and Marcus Owens point out in their article,1 before the enactment of Bill C-33 on May 13, 2005,2 the minister of national revenue could apply only one sanction to a registered charity that did not comply with the requirements of the Income Tax Act3—revocation of the charity’s registration. In practice, the severity of the sanction was such that only the most serious cases of non-compliance were subject to its application. From the viewpoint of registered charities, this lack of middle ground provided a form of protection against inappropriate revocation of their registration. But from the government’s perspective, the minister was left with only the issuance of warnings to deter conduct that did not comply with the requirements of the Act.

When a registered charity was the subject of such warnings, it entered unexplored waters. At what point would the minister consider that the conduct at issue warranted revocation of the charity’s registration? And how long would a warning issued for a particular registered charity remain relevant? Under the new compliance regime, the minister still has the power to revoke the registration of a charity,4 and the issues relating to the determination that the conduct of a registered charity warrants revocation will remain. Presumably, however, the introduction of intermediate sanctions provides for a more progressive application of such a draconian measure.

SANCTIONS

Hayhoe and Owens outline the plethora of new sanctions that were introduced for registered charities. I will review some of those sanctions, the application of which could prove problematic.

Suspension of Privilege To Issue Tax Receipts

The most important feature of a registered charity is the ability to issue tax receipts for the donations it receives, which provides a significant tool to raise funds to finance its activities. The new regime provides for the authority of the minister to suspend, for a period of one year, the privilege of a registered charity to issue tax receipts in six instances:

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2 SC 2005, c. 19.
3 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”). Unless otherwise stated, statutory references in this article are to the Act. “Registered charity” is defined in subsection 248(1) of the Act.
4 See, inter alia, paragraph 168(1)(b), which provides that the minister may give notice proposing to revoke the registration of a charity that no longer complies with the registration requirements of the Act. The actual revocation procedure is described in subsection 168(2).
1. repeat infraction of the rule prohibiting a charitable organization or a public foundation from carrying on a business that is “not a related business”;  
2. repeat infraction of the rule prohibiting a private foundation from carrying on any business;  
3. repeat infraction of the rule against provision of an undue benefit to a person;  
4. issuance of receipts in a taxation year for eligible amounts that in total exceed $25,000, if there is no gift or if the receipt contains false information;  
5. failure to comply with the requirements of sections 230 to 231.5; and  
6. receipt of a donation where it may reasonably be considered that the charity has acted, in concert with another charity that is the subject of a suspension under section 188.2, to accept a transfer of property on behalf of that other charity.

The first three situations entail the repetition of a particular offence (within a period of five years), which could—theoretically—allow the registered charity to take corrective measures to avoid the drastic consequence of the suspension of its privilege to issue tax receipts. However, in the case of the first situation, the notion of a business that is “not a related business” can be difficult to grasp. Subsection 149.1(1) states that a “related business,” in relation to a charity, includes a business that is unrelated to the objects of the charity if substantially all persons employed by the charity in the carrying on of that business are not remunerated for that employment.” Because this definition is not restrictive, what exactly is a business that is related to the objects of the charity remains an issue, as noted by Hayhoe and Owens. As could be expected, the Canada Revenue Agency (CRA) takes a very narrow view of what constitutes a related business.

In *Alberta Institute on Mental Retardation v. The Queen*, the Federal Court of Appeal examined the decision of the minister to refuse the registration of a charity that was created as a fundraising vehicle for other charities. The charity entered into an arrangement with a company operated for profit under which the charity solicited and collected used goods that would then be sold by the company. The charity received a monthly minimum fee and a share of the proceeds of sale. The minister

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5 Paragraph 188.2(1)(a) and subsection 188.1(2).  
6 Ibid.  
7 Paragraphs 188.2(1)(b) and 188.1(4)(b).  
8 Paragraph 188.2(1)(c) and subsection 188.1(9).  
9 Paragraph 188.2(2)(a).  
10 Paragraph 188.2(2)(b).  
11 Supra note 1, at 72-73.  
12 87 DTC 5306 (FCA); leave to appeal to the Supreme Court of Canada refused (1988), 87 NR 397 (SCC).
rejected the application for registration because the charity was not operating exclusively for charitable purposes and was carrying on a business other than a related business.

The majority of the Federal Court of Appeal (Heald and Mahoney JJ concurring) held that since the charity had the power to raise funds for the purpose of carrying out its objects and all monies raised through the agreement with the company were given to registered charitable organizations, the activities of the charity were charitable. As for the nature of the business undertaken by the charity, the majority held that the business was incidental to the charity’s charitable operations because it was only a means to an end.

Finally, the majority of the court examined the minister’s argument that the business undertaken by the charity was not a related business. Since the court had already concluded that the business was incidental to the charity’s charitable operations, it went on to conclude that the business was a related business.

In the minority decision, Pratte J held that an activity does not cease to be commercial only because all of the profits are allocated to a charitable purpose. If the opposite were the case, Pratte J reasoned, the requirement that a public foundation carry on only a related business would be moot. Predictably, the CRA adopted the narrower view of Pratte J. That position tends to be vindicated by the subsequent unanimous decision of the Federal Court of Appeal in *Earth Fund/Fond Pour la Terre v. MNR*.¹³

The Earth Fund charity was denied registration by the minister for two main reasons: its corporate objects were too broad, and it intended to carry on a business that was not a related business. The business in question was the marketing and selling of lottery tickets, the profit from which would be devoted entirely to charitable activities, as was the case in *Alberta Institute*. In a unanimous decision rendered by Sharlow J, the Federal Court of Appeal agreed with the position of the minister. In dealing with the second argument, Sharlow J revisited the *Alberta Institute* decision:

"I do not accept the argument of counsel for the appellant that the *Alberta Institute* case is authority for the proposition that any business is a “related business” of a charitable foundation if all of the profits of the business are dedicated to the foundation’s charitable objects. The Minister in that case was arguing that Alberta Institute was “a wholesaler of goods,” but in fact Alberta Institute was simply soliciting donations of goods which it converted to money. That is somewhat different from the traditional fundraising activities of a foundation, but the difference is only a matter of degree.

By contrast, the appellant proposed to do nothing except market and sell lottery tickets in a manifestly commercial arrangement that will, if all goes as planned, result in a profit that will be donated, I assume, to qualified donees. The appellant is in exactly the same position as any commercial enterprise that commits itself to apply its profits to charitable causes. Such a commitment, by itself, does not derogate from the commercial nature of the activity that generates the profit. Given the particular facts...

¹³ 2003 DTC 5016 (FCA).
of this case, the Minister was justified in concluding that the appellant’s proposed lottery operation would be a business of the appellant that is not “a related business,” and thus would not qualify as a charitable activity.14

While this decision of the Federal Court of Appeal has considerably narrowed the reach of the decision in Alberta Institute, the notion of what is “a related business” remains unclear. The implementation of the penalties under paragraph 188.2(1)(a) and subsection 188.1(2) will probably accelerate the analysis of this notion by the courts.

The fourth situation listed above could trigger some important questions, notably: What is meant by “false information,” and to what extent could a concept of materiality be used to qualify the “false information”? As indicated by Hayhoe and Owens, the information that must be included in a tax receipt under regulation 3501 and proposed amendments is quite extensive.15 Most of the information required is more informative than substantive.

Consider the example of an individual who makes a cash donation of $5,000 to a registered charity. The donation is made by the issuance of a cheque, signed by the individual but payable by a corporation. Objectively, it appears that the donation is made by the corporation, not the individual. If the registered charity agrees to issue the receipt in the name of the individual, does this constitute false information, which could trigger the application of paragraph 188.2(1)(c)? Does the answer to this question differ if the individual signing the cheque explains that he is a shareholder of the corporation and that the $5,000 will be booked as an advance to a shareholder? Questions such as these raise the issue of how far the registered charity must go to satisfy itself that the individual is indeed the true donor.

The fifth situation, dealing with the failure to comply with the provisions of sections 230 to 231.5, also involves considerable uncertainty. Subsection 230(2) outlines in very cryptic language the requirements in terms of the books and records of registered charities. While the requirement in paragraph 230(3)(b) for the retention of copies of the tax receipts issued by the charity should not be an issue, paragraphs 230(2)(a) and (c) constitute a model for the raising of questions of interpretation:

(a) information in such form as will enable the Minister to determine whether there are any grounds for the revocation of [the charity’s] registration under this Act; . . .

(c) other information in such form as will enable the Minister to verify the donations to [the charity] for which a deduction or tax credit is available under this Act.

Arguably, those provisions entail a large measure of subjectivity, since the information must allow the minister to make such determination or verification. What is the required information, and in what form must it be kept? Again, such questions are

14 Ibid., at paragraphs 30-31.
15 Supra note 1, at 77-78.
indicative of considerable uncertainty in the application of this penalty. Moreover, as mentioned by Hayhoe and Owens, the penalty itself is potentially very harsh in the case of inadvertent clerical errors.\textsuperscript{16}

\textbf{Penalty for Incomplete Information}

Subsection 188.1(7) provides for a penalty corresponding to 5 percent of the eligible amount stated on a tax receipt (increased to 10 percent, under subsection 188.1(8), for a repeat infraction within a five-year period) when the receipt is not issued in accordance with the Act and the Regulations. As mentioned above, the Regulations provide a long list of information that must be included on the receipt. Again, these provisions raise questions about the nature and extent of the error or omission that will be sufficient to trigger application of the penalty.

\textbf{RECOUSE PROCEDURES}

The new compliance regime includes new and amended recourse procedures for charities to which the sanctions apply.

\textbf{Appeal Process for Penalties}

The new rules permit a charity to dispute the assessment of penalties through the normal process of objection and appeal to the Tax Court of Canada.\textsuperscript{17} Such an addition was necessary to ensure a proper balance between compliance with the requirements of the Act and the efficient management of registered charities.

\textbf{Revocation of Registration}

Under the old regime, the only recourse available to a charity subject to revocation of its registration was appeal to the Federal Court of Appeal.\textsuperscript{18} Under the new regime, the Federal Court of Appeal remains the jurisdiction in which to dispute this sanction. However, the objection process is now also available to a charity faced with revocation\textsuperscript{19}—an addition that is a long overdue.

As for any tax files, the charity will be able to have full access (as permitted by section 241) to the CRA’s file and thus to understand clearly the issues that led to the decision to revoke its registration, prior to the Federal Court of Appeal process. The principal of the charity will then be able to discuss those issues more fully with CRA officials and provide, if necessary, additional information concerning the activities of the charity.

\textsuperscript{16} Ibid., at 80-81.

\textsuperscript{17} Subsection 189(8).

\textsuperscript{18} Subsection 180(1).

\textsuperscript{19} Subsection 168(4).
The objection process will also provide an additional step prior to actual revocation of the charity’s registration where negotiations can occur with CRA officials to determine what changes, if any, would satisfy the CRA that the charity will operate in compliance with the Act. In many files, the CRA’s reasons for proceeding with revocation target only some of the charity’s activities or objects. In such a situation, it could be possible to eliminate the contentious issues so that the charity can remain registered (though obviously this will not always be the case).

While the new objection process is clearly a welcome addition, it should be seen as only a first step. For cases where the revocation is upheld at the conclusion of the objection process, the Tax Court of Canada should be designated as the first jurisdiction of appeal. Unlike the Federal Court of Appeal, which must generally rely entirely on documentary evidence and affidavits filed by the parties in reaching its decision, the Tax Court of Canada can hear witnesses. Since the reasons for revocation of registration are very much fact-driven, the testimony of witnesses would provide a clearer factual background and allow the tribunal to assess, if necessary, the credibility of the charity’s principals. Admitting the evidence of witnesses would also permit the cross-examination of the CRA official(s) responsible for the revocation decision, which would presumably provide confirmation with regard to the official’s understanding of the factual situation and the circumstances that led to the decision. It is submitted that such a process would clearly better serve the public interest than the current jurisdiction of the Federal Court of Appeal as the first tribunal to hear the dispute between the parties.

Suspension of Privilege To Issue Tax Receipts

A registered charity that is the subject of a one-year suspension of its privilege to issue tax receipts under subsection 188.2(1) or (2) can file a notice of objection. When the notice of objection is filed, the charity can apply to the Tax Court of Canada for a postponement of that portion of the period of suspension that has not elapsed, until the time determined by the court. Subsection 188.2(5) provides that the court “may grant an application for postponement only if it would be just and equitable to do so.” The Act is otherwise silent on the criteria that should be

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20 Section 351 of the Federal Court Rules, 1998, SOR/98-106, as amended, provides that in special circumstances, the court may grant leave to a party to present evidence on a question of fact. The threshold for the exercise of such discretion by the court is very high. In *Lubrication Engineers, Inc. v. Can. Council of Prof. Eng.*, [1990] 2 FC 525 (CA), the court applied the following threefold test: (1) the evidence must be conclusive of an issue; (2) it must be credible; and (3) it could not have been obtained by reasonable diligence before the end of the trial. In the case of a decision to revoke the registration of a charity, there is no trial, but the decision is taken in the course of an administrative process of the CRA. By extension, the court’s third criterion could be applied to the evidence submitted by the charity in the course of the CRA’s audit.

21 Subsection 189(8).

22 Subsection 188.2(4).
applied by the Tax Court in the course of reviewing an application for postponement. The following considerations will likely be relevant:

- the impact of the suspension on the charity’s operations;
- the impact of the suspension on the long-term financial viability of the charity;
- the history of the charity with regard to compliance with the requirements of the Act and Regulations;
- the nature of the offence that led to the suspension;
- the risk that the charity will repeat the offence;
- the undertakings of the charity to ensure future compliance with the Act and Regulations;
- the activities of the charity.

Suspension of the privilege to issue tax receipts is arguably the most drastic penalty before revocation of a charity’s registration. Accordingly, one hopes that the CRA will use this sanction as a tool of last resort, and apply it in only the most extreme cases.

**Due Diligence Defence**

The penalty for the failure to file an information return as and when required\(^\text{23}\) and the penalty for incorrect information in tax receipts\(^\text{24}\) could be classified as automatic penalties; that is, they do not require specific intent in order to be applicable. For those penalties, it is arguable that the due diligence defence will be available.\(^\text{25}\)

In the past, the CRA has resisted accepting the existence of such a defence, but the ruling of the Federal Court of Appeal in *A-G Canada v. Consolidated Canadian Contractors Inc.*\(^\text{26}\) has confirmed its application in tax matters. While the courts have accepted the due diligence defence in only a minority of cases, it may provide an additional argument against the application of some of the new penalties.

**Fairness Provisions**

Subsection 220(3.1) provides authority for the minister to waive or cancel penalties and interest calculated under the Act. Nothing in the changes to the charity tax regime would prevent the application of such fairness provisions.

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23 Subsection 188.2(6).
24 Subsection 188.2(7).
26 98 GTC 6303 (FCA).
While the minister follows strict guidelines when applying subsection 220(3.1),\(^{27}\) it remains to be seen whether the minister will be more generous in the application of this provision to registered charities, considering the public interest of their mission and the fact that their income is not taxable.\(^ {28}\) With regard to the former, query whether the minister could be allowed to consider whether the public interest would be better served if the registered charity were out of pocket as a result of the application of a penalty or if the charity were allowed to spend the same amount on a charitable cause. Obviously, this consideration could never be determinative, for the contrary would entail that registered charities would never be subject to penalties; but one wonders if it could at least be part of the analysis.

**CRA Procedure**

An official of the Charities Directorate of the CRA has confirmed that the application of any penalty under the new compliance regime will be subject to a procedure that is still under review. As it currently stands, the procedure would have the auditor in the field prepare a report recommending the application of penalties.\(^ {29}\) Such a report will have to be approved by the auditor’s immediate supervisor and will be drafted in consultation with a technical adviser from the Charities Directorate. The actual letter of intention to apply the penalties will be signed by a senior official in the Charities Directorate (yet to be determined). This procedure is designed to ensure uniform application of the penalties across the country.

As of January 26, 2006, no file had been recommended for the application of penalties. The Charities Directorate has confirmed that it intends to work with registered charities to help them comply with the requirements of the Act and would thus favour the settlement of irregularities by signing a compliance agreement with the particular charity instead of applying penalties. A compliance agreement would spell out in detail the corrective measures that the charity would need to apply in order to ensure compliance with the requirements of the Act. Of course, such an approach might not be warranted in cases of fraud or blatant disregard for the application of the Act.

At the time this article was written, the Charities Directorate was preparing a document outlining its position concerning the application of penalties and the procedure (outlined above) that will be followed. The directorate set the beginning of March 2006 as a target for the release of the document on its Web site,\(^ {30}\) followed eventually by a bulletin or information circular. While such a document

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28 Paragraph 149(1)(f).

29 The same procedure is followed for the application of penalties under subsection 163(2).

will not have any legal weight, it will surely provide much-needed guidance to registered charities and their representatives as to the position of the CRA.

Only time will tell how this procedure will affect the actual application of the penalties to registered charities. If the Charities Directorate does indeed favour the signature of compliance agreements instead of the application of penalties, many of the issues discussed in this article may not arise for the charities concerned. It will be interesting to follow the evolution in the approach of the CRA in that regard.