The New Tax Sanctions for Canadian Charities: Learning from the US Experience*

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PRÉCIS

Jusqu’à tout récemment, la révocation de l’enregistrement représentait pour l’Agence du revenu du Canada (ARC) la seule sanction à sa disposition quand un organisme de bienfaisance violait les règles fiscales qui les régissent. En 2004, le gouvernement fédéral a proposé de nouvelles mesures pour resserrer le régime de conformité fiscale des organismes de bienfaisance, incluant l’instauration de sanctions de sévérité moyenne comme des impôts de pénalité et la suspension de la capacité de l’organisme d’émettre des reçus officiels de dons. La législation mettant en œuvre les propositions a été adoptée en mai 2005. Bien que nous n’ayons pas obtenu de directives détaillées de l’ARC sur la façon dont elle compte gérer le nouveau régime, l’expérience américaine de sanctions semblables peut donner à entendre comment les sanctions canadiennes devraient s’appliquer. Cet article compare les deux régimes et critique l’aspect politique de certains aspects des règles canadiennes.

ABSTRACT

Until recently, the only sanction available to the Canada Revenue Agency (CRA) where a registered charity violated the charity tax rules was revocation of the charity’s registration. In 2004, the federal government proposed new measures to strengthen the charity tax compliance regime, including the introduction of intermediate sanctions, such as penalty taxes and suspension of the ability to issue official donation receipts. Legislation implementing the proposals was enacted in May 2005. While we do not yet have detailed guidance from the CRA on how it will administer the new compliance


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regime, the US experience with similar sanctions may suggest how the Canadian sanctions should be applied. This article compares the two regimes and offers a policy critique of certain aspects of the Canadian rules.

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

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**INTRODUCTION**

Until recently, the Canadian tax system provided the Canada Revenue Agency (CRA) with only one real sanction against a registered charity that violated the charity tax rules—revocation of the charity’s registration. In May 2005, however, the Income Tax Act was amended to introduce intermediate sanctions.1 This marked

1 Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”). The amendments to the charity tax rules were enacted by SC 2005, c. 19, given royal assent May 13,
a revolutionary change in Canadian charity tax law. The impetus for reform of the charity tax compliance regime came from the Voluntary Sector Initiative (VSI), a four-year consultative process between the federal government and the Canadian charitable (or voluntary) sector, with input also from the public.2 One of the VSI working groups was the Joint Regulatory Table (JRT), whose mandate included discussion and analysis of the existing regime for tax regulation of the charitable sector. The JRT’s final report, issued in March 2003,3 recommended significant changes in a number of areas, including, notably, the introduction of intermediate sanctions. In March 2004, the federal budget introduced proposals to implement the JRT’s recommendations for a new compliance regime and reform of other aspects of the regulatory framework.4 With the enactment of the legislation, it is important that we begin to understand the consequences of these changes for the charitable sector.

Because intermediate sanctions are new to Canada, we do not yet have detailed guidance from the CRA Charities Directorate on how these provisions will be administered. However, some direction may be taken from the US experience with similar sanctions. Although there are important differences between the Canadian and the US compliance regimes, the general policy behind intermediate sanctions is the same in both jurisdictions. Moreover, some apparent differences may actually be ascribed to terminology: in the US regime, “intermediate sanction” refers to a specific excise tax, enacted in 1996, which is applicable to a particular class of related-party transactions;5 the term does not include a host of additional—and, in some cases, much older—sanctions that are “intermediate” in the sense that their application penalizes certain institutional behaviour without terminating a charity’s tax-exempt status. Accordingly, in attempting to predict how the new Canadian sanctions will be administered, we will compare the Canadian regime with the full range of US sanctions and penalties.

We will first describe the US regime (including a brief history of tax compliance enforcement mechanisms). We will then describe in more detail the Canadian

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5 Section 4958 of the Internal Revenue Code of 1986, as amended (herein referred to as “the Code”); see infra note 20 and the discussion under the heading “The Section 4958 Excise Tax.”
intermediate sanctions, comparing and contrasting them with the US sanctions. We will use this comparison, along with our knowledge of past CRA enforcement priorities and administrative practices, as a framework for discussion and analysis of how the Canadian sanctions may be interpreted and applied. We will also discuss, briefly, the changes to the rules governing revocation and appeals.

THE US COMPLIANCE REGIME

Background

Under US federal tax law, corporations, trusts, and associations that are organized and operated exclusively for charitable purposes qualify for exemption from federal income tax, provided that “no part of the net earnings of [the organization] inures to the benefit of private individuals.” In addition to the proscription of private inurement of income, charities are prohibited from intervening in political campaigns and are subject to a limitation, but not a prohibition, on lobbying or attempts to influence legislation. Exemption is not automatic but conferred on application to the Internal Revenue Service (IRS). Once recognized as tax-exempt, the applicant is classified as either a private foundation or a publicly supported charity. The distinction is generally based on the organization’s pattern of income. Private foundations are supported by donations from a small group or even a single donor, or by income from an endowment or similar investment portfolio. Publicly supported charities, in contrast, have a broader base of funding from the general public, in the form of contributions or fees for goods or services. Certain organizations—namely, churches, schools, and hospitals—are automatically classified as publicly supported charities on the basis of their activities.

Before 1969, the only remedy or sanction for violation of the statutory requirements for exemption by either a private foundation or a publicly supported charity was revocation of tax-exempt status. To provide an alternative to the drastic step of revocation, and to channel foundation behaviour, the US Congress created a system of excise taxes, applicable solely to private foundations, which was enacted as part

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7 *Code section 501(c)(3). In the United States, the rubric “charitable” often encompasses the full range of purposes set out in the statute, which include “religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition . . . or for the prevention of cruelty to children or animals.” This is a broader category than the meaning ascribed to “charitable purposes” or “charitable activities” in Canadian tax law. (The Canadian tax law definition of “charity” is based on English common law.)

8 The filing requirement is set out in Code section 508. The application for exempt status (IRS form 1023, “Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code”) requires a detailed description of the structure and proposed activities of the applicant organization.
of the Tax Reform Act of 1969. The excise tax regime imposed penalty taxes for specified misuses of funds, including

- self-dealing (financial transactions with insiders);\(^9\)
- failure to annually expend sufficient funds for charitable purposes;\(^10\)
- ownership of excessive percentages of stock in business enterprises;\(^11\)
- making high-risk investments;\(^12\) and
- making grants for non-charitable and certain other purposes.\(^13\)

Depending on the particular excise tax involved, liability for the applicable tax may lie with the foundation, with a party who received the benefit of a self-dealing transaction, or with a foundation manager who approved the particular action contravening the excise tax regime. The excise taxes are tiered. The first-tier tax (or “initial penalty”) is coupled with a requirement of correction. A second tier of significantly higher taxes applies if timely correction has not been made. Finally, a third-tier tax (calculated as the lesser of the aggregate tax benefit from tax-exempt status and the net assets of the foundation) is triggered by wanton and flagrant violation of the excise tax regime.\(^14\) The third-tier tax essentially results in confiscation of the foundation’s assets. Loss of tax-exempt status will thus occur, in most cases, only after the excise taxes have failed to change the behaviour of the foundation.

While this excise tax regime applied only to private foundations, the concept of a tax penalty short of revocation of tax-exempt status was generally seen as desirable, effective, and proportional to the transgression.\(^15\) Congress used the same approach in 1976 to constrain the lobbying activities of publicly supported charities, by introducing an excise tax to be applied against the amount of lobbying expenses in excess of authorized levels.\(^16\) In 1987, Congress again employed the excise tax model to encourage compliance with the rules prohibiting political campaign intervention;\(^17\) however, in contrast to the penalty taxes applicable to private foundations or for excessive lobbying activities, the IRS was authorized to assess the excise tax as an

\(^9\) Code section 4941.
\(^10\) Code section 4942.
\(^11\) Code section 4943.
\(^12\) Code section 4944.
\(^13\) Code section 4945.
\(^14\) Code section 507.
\(^16\) Code sections 4911 and 4912.
\(^17\) Code section 4955.
additional, and not necessarily an intermediate, sanction.\textsuperscript{18} Clearly, the IRS viewed excise taxes as a useful and effective tool for modifying the behaviour of charities.\textsuperscript{19}

It was against this background that Congress held hearings in 1993 to examine the need for additional statutory rules addressing violations of the basic prohibition in respect of inurement of income of a charity found in section 501(c)(3) of the Code. As a result of the hearings, legislation was proposed that would apply the excise tax concept to inurement. The proposals were eventually enacted in 1996 as section 4958 of the Code.\textsuperscript{20}

The Section 4958 Excise Tax\textsuperscript{21}

Section 4958 provides for an excise tax on “excess benefit transactions” between a publicly supported charity and a “disqualified person” with respect to the charity.\textsuperscript{22} The excise tax does not apply to private foundations, which continue to be subject to the self-dealing excise tax in section 4941. The section 4958 excise tax, popularly known in the United States as the “intermediate sanction” tax, provides an alternative to revocation of tax-exempt status in the case of inurement of the charity’s income to persons with a controlling influence. However, the Treasury department and the IRS take the position that, even where the tax penalty is applied, revocation is still possible in appropriate circumstances.\textsuperscript{23}

\textsuperscript{18} Treas. reg. section 53.4955-1.

\textsuperscript{19} For example, as early as 1989, an IRS internal study recommended extending a number of the penalties under the private foundation excise tax regime to publicly supported charities. Internal Revenue Service, Executive Task Force, “Commissioner’s Penalty Study: Report on Civil Penalties,” February 22, 1989.

\textsuperscript{20} Section 4958 was added to the Code by section 1311(a) of the Taxpayer Bill of Rights 2, Pub. L. no. 104-168, signed into law by President Clinton on July 30, 1996 and effective for transactions occurring after September 13, 1995.


\textsuperscript{22} The excise tax also applies to transactions between social welfare organizations recognized as exempt from federal income tax under section 501(c)(4) of the Code (section 4958(e)). Section 501(c)(4) is the category of tax exemption that applies to advocacy groups that engage in significant lobbying activity. Section 4958 also treats formerly tax-exempt organizations as if they were still tax-exempt for a period of five years after loss of tax-exempt status.

\textsuperscript{23} Treas. reg. section 53.4958-8(a). In fact, in the first and, as of this writing the only, section 4958 case to be litigated, Michael T. Caracci, 118 TC 379 (May 22, 2002), the IRS did exactly that, revoking the tax-exempt status of each of the three charities involved in the excess benefit transaction. The Tax Court, however, ruled in favour of the organizations on the exemption issue and in favour of the IRS on section 4958. An appeal of the section 4958 decision is pending in the US Court of Appeals for the Fifth Circuit. The government did not appeal the ruling on tax-exempt status. However, on September 8, 2005, the Treasury department released for public comment proposed regulations confirming that revocation of tax-exempt status and imposition of the excess benefits excise tax can both occur in certain circumstances. The proposed regulations take the position that all relevant facts and circumstances should be
Again, the excise tax is tiered. The initial tax is 25 percent of the excess amount, to be paid by the disqualified person who received the excess benefit. In addition, there is a requirement that the parties correct the violation by undoing the excess benefit transaction, typically by repayment of the excess amount to the charity. If correction does not occur before the date the IRS formally notifies the disqualified person of liability for the tax, a second-tier excise tax of 200 percent of the excess amount is imposed. However, the second-tier tax may be abated if correction occurs within 90 days of formal notification of liability.24

In addition to the tax paid by the disqualified person, if a manager of the organization knowingly participated in the excess benefit transaction, that person will be liable for an excise tax of 10 percent of the excess amount, unless the participation was not willful and was due to reasonable cause. The amount of the tax is subject to a cap of $10,000 for each excess benefit transaction.25

“Disqualified Person”

The statute defines “disqualified person” as any person who was in a position to exercise substantial influence over the affairs of the particular charity at any time during the five years immediately preceding the transaction in question.26 Pursuant to regulations, the category of disqualified persons includes voting members of the charity’s governing body and persons who exercise the powers of a president, chief executive, chief operating officer, treasurer, or chief financial officer.27 The regulations also provide that other persons may be disqualified persons by virtue of particular facts and circumstances. The specific factors tending to demonstrate substantial influence include the following:28

- The person was a founder of the charity.
- The person is or was a substantial contributor to the charity during the five years preceding the transaction.

24 Treas. reg. section 53.4958-1.

25 Because a manager of the organization who participated in the transaction may also be the recipient of the excess benefit, and because an IRS statutory notice of deficiency issued for section 4958 excise tax will assume that correction has not occurred, it is possible for an enormous sum to be assessed by the IRS in these cases. For example, in Caracci, supra note 23, the statutory notices of deficiency totalled approximately $41.7 million. As noted, the Tax Court sustained the IRS’s position on the excise taxes, but that decision has been appealed.

26 Code section 4958(f).

27 Treas. reg. section 53.4958-3(c).

28 Treas. reg. section 53.4958-3(e)(2).

Note: The above text contains placeholders and references that were not resolved in the provided document.
The person’s compensation is based primarily on revenues from activities of the organization that the person controls.

- The person has or shares authority to control or determine a substantial portion of the organization’s capital expenditures, operating budget, or employee compensation.
- The person manages a discrete segment or activity of the charity that represents a substantial portion of the organization’s activities, assets, income, or expenses.
- The person owns a controlling interest in a corporation, partnership, or trust that is itself a disqualified person.
- The person is a non-stock organization controlled directly or indirectly by one or more disqualified persons.

The “disqualified person” designation also applies to a disqualified person’s spouse, ancestors, siblings, spouses of siblings, and descendants (through to great-grandchildren) together with their spouses.\(^{29}\) It also extends to any entity at least 35 percent of which is controlled by a disqualified person as measured by stock ownership, profits interest, or, in the case of an estate or trust, beneficial interest.\(^{30}\)

The regulations also specify facts and circumstances that demonstrate that a person does not exercise substantial influence over a charity. These factors include the following:\(^{31}\)

- The person has taken a bona fide vow of poverty on behalf of a religious organization.
- The person’s sole relationship to the charity is as an independent contractor providing professional advice.
- The person is a donor and does not receive more benefits than any other person who donates the same amount.
- The person is an employee of the charity and the direct supervisor of the person is not a disqualified person.
- The person does not participate in any management decisions affecting the charity as a whole or regarding a significant segment of the organization.

In addition, the regulations provide that an employee of the charity whose compensation is less than $80,000 per year, and who is not a disqualified person on some other basis, is not a disqualified person.\(^{32}\)

**“Excess Benefit Transaction”**

An excess benefit transaction to which the excise tax applies is any transaction in which the value of the benefits provided by the charity exceeds the value of the

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\(^{29}\) Treas. reg. section 53.4958-3(b)(1).

\(^{30}\) Treas. reg. section 53.4958-3(b)(2).

\(^{31}\) Treas. reg. section 53.4958-3(e)(3).

\(^{32}\) Treas. reg. section 53.4958-3(d)(3).
consideration, including the provision of services.\textsuperscript{33} In determining whether an excess benefit has been provided in any particular transaction or financial relationship, all consideration and benefits that pass between the disqualified person and the applicable charity are taken into account; in addition, property involved in the transaction is included at fair market value.\textsuperscript{34}

An excess benefit transaction does not include reasonable compensation for goods or services.\textsuperscript{35} For purposes of assessing the reasonableness of compensation, all forms of cash and non-cash compensation paid to the disqualified person are taken into account. The definition employed is very broad and includes the following: deferred compensation; all compensatory benefits, whether or not they are included in gross income for income tax purposes; and all taxable and non-taxable fringe benefits except those specifically excluded under section 132 of the Code (such as de minimis and working condition fringe benefits). In order to be treated as compensation for goods or services in the section 4958 analysis, the benefit in question must have been treated as compensation by the organization at the time it was paid, as demonstrated by contemporaneous written documentation, assuming that the benefit constitutes taxable income to the disqualified person.\textsuperscript{36}

\textbf{The Rebuttable Presumption of Reasonableness}

The statute itself is silent on how the reasonableness of compensation or of other financial transactions is to be determined for purposes of section 4958. However, the legislative history of section 4958 contains a recommendation that the Treasury department and the IRS establish a procedure in administrative regulations issued under the statute that would provide for a rebuttable presumption of reasonableness when an appropriate process has been followed in setting compensation or authorizing a particular transaction.\textsuperscript{37} The presumption set out in the regulations has three elements:\textsuperscript{38}

\begin{itemize}
\item \textsuperscript{33} Treas. reg. section 53.4958-1(b).
\item \textsuperscript{34} Treas. reg. section 53.4958-4. Treas. reg. section 53.4958-4(b)(1)(i) defines “fair market value” as the price agreed upon by a willing, knowledgeable buyer and a willing, knowledgeable seller.
\item \textsuperscript{35} Treas. reg. section 53.4958-4(b).
\item \textsuperscript{36} In one of the apparently few enforcement actions taken, the IRS concluded that undocumented loans, automobiles, and insurance payments all constituted excess benefits. See TAM 200243057, July 2, 2002. (A TAM, or technical advice memorandum, is an analysis by the IRS National Office acting in an internal appellate capacity.)
\item \textsuperscript{37} HR rep. no. 104-506, 104th Cong., 2d sess. (March 28, 1996), 56. This is in contrast to the approach taken with regard to Code section 4941(d)(2)(E), establishing a similar reasonable standard for compensation paid to officers and directors of private foundations, in which both the statute and the legislative history are silent on how “reasonableness” of compensation should be determined. From a practical perspective, one would logically expect that the procedures for establishing reasonable compensation under Code section 4958 would be equally effective for establishing reasonable compensation under Code section 4941, but the IRS has yet to formally adopt such an approach.
\item \textsuperscript{38} Treas. reg. section 53.4958.6.
\end{itemize}
1. The transaction or compensation is approved by the organization’s governing body, or a committee of the governing body, and no member of the approving body has a conflict of interest with respect to the transaction or compensation.

2. The governing body or committee obtains and relies on appropriate data on comparability before approving the transaction.

3. The governing body or committee adequately documents its analysis and decision.

Adherence to the preceding steps gives rise to a presumption of reasonableness that can be rebutted only if the IRS develops sufficient evidence questioning the probative value of the comparability data relied upon by the decision-making body.\(^39\) However, the regulations specifically provide that no inference can be drawn from a failure to follow the steps for the presumption.\(^40\)

Clearly, the cornerstone of establishing the presumption is the use of appropriate comparability data.\(^41\) The regulations suggest a number of sources of such data but do not mandate any particular set. In the case of property transactions, for example, current appraisals by independent firms and offers received in open and competitive bidding are suggested as appropriate markers of reasonableness. In the case of compensation, the regulations place emphasis on

- compensation paid by similarly situated taxable and tax-exempt organizations for functionally comparable positions;
- the availability of similar services in the same geographic area;
- current compensation studies compiled by independent firms; and
- actual written offers from similar institutions competing to hire the person whose compensation is being appraised.

Smaller organizations, defined as those with annual gross receipts of less than $1 million, can establish the presumption for compensation simply by obtaining data regarding the amounts paid by three comparable organizations in the same or similar communities for similar services.

**Reporting of Violations**

The US excise taxes are intended to be self-assessed: a tax-exempt organization that discovers that it has transgressed the rules is required to report the violation (using tax form 4720) and pay the appropriate tax penalty. No study has yet been done on whether publicly supported charities are reporting and self-assessing the excise tax

\(^{39}\) Treas. reg. section 53.4958-6(b).

\(^{40}\) Treas. reg. section 53.4958-6(e).

on excess benefit transactions. However, in 1990, the IRS published the results of a study of private foundations’ compliance with their excise tax regime. Not unexpectedly, the IRS found that only 1 percent of private foundations that had violated one or more of the excise tax rules reported the violation.42

More recently, the IRS has embarked on a review of the compensation practices of approximately 2,000 charities, including private foundations (which also are governed by a standard of reasonableness, by virtue of section 4941 of the Code, similar to that set out under section 4958).43

CANADA’S COMPLIANCE REGIME 44

As described in the introduction to this article, the Act was amended recently to provide for the application of intermediate sanctions to Canadian registered charities. Before we explore the significance of this change for charity tax regulation in Canada, it is helpful to describe briefly the old compliance regime and the perceived problems that the new regime is intended to address.

The Previous Regime

Under the old regime, the CRA had the authority to audit the operations of a charity to determine compliance with the charity tax rules. However, if it found non-compliance, the only sanction available was revocation of the charity’s registration.45

Revocation results in the charity’s immediate loss of both tax-exempt status46 and the ability to issue tax receipts. Thus, any subsequent donors were denied the benefit of tax recognition for gifts to the charity.47 On an even more punitive note, one year after revocation, the charity would be subject to a revocation tax equal to all of its assets at the time of revocation (less deductions for legitimate expenses and grants to other registered charities made within the previous year).48

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45 This sanction was applied primarily pursuant to subsections 149.1(2), (3), and (4) of the Act.
46 Only a registered charity is exempt from tax under paragraph 149(1)(f) of the Act; unregistered charities are taxable by implication of paragraph 149(1)(l). See Robert B. Hayhoe, “An Updated Introduction to the Taxation of Non-Profit Organizations” (2004) vol. 18, no. 2 The Philanthropist 91-108, at 95.
47 A gift to an unregistered charity does not entitle an individual donor to a tax credit pursuant to section 118.1 or a corporate donor to a tax deduction pursuant to section 110.1.
48 Section 188.
In most circumstances where a CRA Charities Directorate audit disclosed non-compliance, on completion of the audit the CRA would issue a letter noting areas of non-compliance and requiring the charity to undertake to amend its practices. If the non-compliance was very serious or the charity refused to cooperate with the CRA, an “administrative fairness letter” proposing revocation of registration would be sent.49

The process was cumbersome, inefficient, and often ineffective.50 There were many delays, as well as inconsistencies in the application of the rules. Because the only available sanction was too harsh in most circumstances (revocation was sometimes referred to as “capital punishment”), the CRA was reluctant to impose it and was therefore viewed by some charities as being ineffective at ensuring compliance. At the same time, more cautious charity executives worried (perhaps unnecessarily) about possible exposure to revocation for minor non-compliance.

Constitutional Issues Associated with Intermediate Sanctions

While it is clear that the old compliance regime was flawed, the solution of introducing intermediate sanctions, such as penalty taxes, raises the question of the federal government’s constitutional authority to do so. It has been suggested that some intermediate sanctions may be susceptible to constitutional challenge on a division-of-powers basis.51

Generally, it is considered that the federal government’s involvement in the regulation of charities is properly confined to its role as a taxing authority.52 To the extent that the conditions for applying an intermediate sanction are relevant to the tax-exempt status of the organization as a registered charity under the Act, the imposition of the sanction is likely a proper exercise of federal jurisdiction. If, however, some or all intermediate sanctions are intended to control the behaviour of charities and to protect the public by preventing abuses, those sanctions may well be ultra vires the federal Parliament. Even if the ostensible purpose of the sanctions is a permitted

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49 In Scarborough Community Legal Services v. The Queen, 85 DTC 5102; [1985] 1 CTC 98, the Federal Court of Appeal concluded that, pursuant to administrative law, the CRA had a duty to provide a charity with notice and an opportunity to respond prior to revocation of charitable registration.


51 See, for example, Manwaring and Hayhoe, supra note 44, at 8:13. Section 91(3) of the Constitution Act, 1867, 30 & 31 Vict., c. 3 (UK), gives legislative jurisdiction over taxation to the federal government; section 92(7) gives legislative jurisdiction over charities to the provinces.

52 See, for example, Patrick J. Monahan and Elie S. Roth, Federal Regulation of Charities: A Critical Assessment of Recent Proposals for Legislative and Regulatory Reform (Toronto: York University Press, 2000). However, it may be argued that interprovincial operations of charities properly fall under the federal government’s residual jurisdiction over “peace, order and good government”: see Robert B. Hayhoe, “An Introduction to Canadian Tax Treatment of the Third Sector” (2004) vol. 6, no. 2 International Journal of Not-for-Profit Law (online: http://www.icnl.org.journal/default.htm).
tax purpose, they may still be ultra vires if that purpose is merely an attempt to cloak a matter properly falling under provincial regulatory authority in the garment of federal jurisdiction.\(^{53}\)

There has been no litigation and very little commentary on the jurisdictional aspects of the tax regulation of charities in Canada. It is therefore difficult to predict with certainty whether some or all of the new intermediate sanctions could be attacked successfully. By contrast, there is no doubt that the US regime described above is constitutionally valid.

**The New Regime**

In proposing a new compliance regime, the 2004 federal budget described the first level of compliance action as additional specific and general education for charities about the applicable tax rules.\(^{54}\) CRA officials have confirmed that they will, in the first instance, make increased use of compliance agreements with non-compliant charities.\(^{55}\) In the United States, the IRS has sent similar signals. In early 2001, it requested public comments on the nature and structure of a program of negotiated settlements of tax disputes involving tax-exempt organizations.\(^{56}\) However, no structured program has yet been announced.

To address more serious non-compliance or where non-compliance is an ongoing concern, the second level of compliance action proposed in the budget, and implemented in the recent legislative amendments, was the introduction of intermediate sanctions, to give the CRA more effective enforcement tools. These intermediate sanctions include suspension of the ability of a charity to issue tax receipts for donations and assessment of a penalty tax of more than 100 percent of funds improperly spent. Additional changes were also to be made to the rules governing revocation and appeals. The new compliance measures are discussed below.

**The Intermediate Sanctions**

The new intermediate sanctions are contained in section 188.1 of the Act. Table 1 summarizes these provisions, indicating the tax or other penalty imposed for each type of infraction of the charity tax rules. The discussion that follows considers how the CRA may interpret and apply the sanctions. For this purpose, we refer to previous CRA administrative policy and practice, and, where appropriate, to the application of similar sanctions under the US compliance regime.


\(^{54}\) Budget Plan, supra note 4, at 351.

\(^{55}\) As described earlier, it has been the CRAs practice in the past to attempt to resolve audits by threatening revocation unless a charity provides a written undertaking to comply in future (see, for example, Canadian Magen David Adom for Israel v. MNR, 2002 DTC 7353 (FCA)).

\(^{56}\) Announcement 2001-14, 2001-7 IRB 648. Like the CRA, the IRS has long used closing agreements to resolve audits. See Code section 7121 and section 8.13.1 of the Internal Revenue Manual (online: http://www.irs.gov.irm/).
<table>
<thead>
<tr>
<th>Infraction</th>
<th>First infraction</th>
<th>Repeat infraction (repeated infractions will increase the probability of revocation)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Late filing of annual information return (T3010A)</td>
<td>$500 penalty</td>
<td>$500 penalty</td>
</tr>
<tr>
<td>Issuing receipts with incomplete information</td>
<td>5% penalty on the eligible amount stated on the receipt</td>
<td>10% penalty on the eligible amount stated on the receipt</td>
</tr>
<tr>
<td>Failure to keep proper books and records</td>
<td>Suspension of tax-receipting privileges</td>
<td>Suspension of tax-receipting privileges</td>
</tr>
<tr>
<td>Charitable organization or public foundation carrying on an unrelated business</td>
<td>5% penalty on gross unrelated business revenue earned in a taxation year</td>
<td>100% penalty on gross unrelated business revenue earned in a taxation year and suspension of tax-receipting privileges</td>
</tr>
<tr>
<td>Private foundation carrying on any business</td>
<td>5% penalty on gross business revenue earned in a taxation year</td>
<td>100% penalty on gross business revenue earned in a taxation year and suspension of tax-receipting privileges</td>
</tr>
<tr>
<td>Foundation acquires control of a corporation</td>
<td>5% penalty on dividends paid to the charity by the corporation</td>
<td>100% penalty on dividends paid to the charity by the corporation</td>
</tr>
<tr>
<td>Undue personal benefit provided by a charity to any person (e.g., a charity makes a cash gift to the director's son)</td>
<td>105% penalty on the amount of undue benefit</td>
<td>110% penalty on the amount of undue benefit and suspension of tax-receipting privileges</td>
</tr>
<tr>
<td>Making a gift to an entity other than a qualified donee as defined in the Act</td>
<td>105% penalty on the amount of the gift</td>
<td>110% penalty on the amount of the gift</td>
</tr>
</tbody>
</table>

(Table 1 is concluded on the next page.)
<table>
<thead>
<tr>
<th>Infraction</th>
<th>First infraction</th>
<th>Repeat infraction (repeated infractions will increase the probability of revocation)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issuing receipts if there is no gift or if the receipt contains false information (where the eligible amounts in total do not exceed $25,000)</td>
<td>125% penalty on the eligible amount stated on the receipt</td>
<td>125% penalty on the eligible amount stated on the receipt</td>
</tr>
<tr>
<td>Issuing receipts if there is no gift or if the receipt contains false information (where the eligible amounts in total exceed $25,000)</td>
<td>Suspension of tax-receipting privileges and 125% penalty on the eligible amount stated on the receipt</td>
<td>Suspension of tax-receipting privileges and 125% penalty on the eligible amount stated on the receipt</td>
</tr>
<tr>
<td>Transferring funds to another registered charity so as to delay expenditures on charitable activities</td>
<td>The charities involved are liable for the amounts transferred plus a 110% penalty on those amounts</td>
<td>The charities involved are liable for the amounts transferred plus a 110% penalty on those amounts</td>
</tr>
</tbody>
</table>

Inappropriate Business Activities

While a private foundation is prohibited from carrying on any business activities, a charitable organization or a public foundation may carry on a “related business.” Public foundations and charitable organizations may also carry on other business activities if substantially all (that is, 90 percent or more) of the staff involved in these activities are volunteers.

In the United States, charities may directly operate or own businesses that are substantially related to their charitable purposes, other than as a source of funds. The income of any unrelated trade or business that is carried on substantially with volunteer labour is exempt from tax. In addition, certain passive income, such as interest, dividends, rent, and royalties, is generally excluded from the calculation of taxable income, although it may come from business activities unrelated to the charitable purposes of the recipient organization. Whether a particular business activity is substantially related to a charity’s purposes is a subjective and difficult determination, and the allocation of expenses between related and unrelated activities is equally difficult. Perhaps as a result, relatively few US charities voluntarily file returns in respect of income from unrelated trades or businesses, and of those that do, a significant percentage report net losses from the activity.


58 Paragraph 149.1(4)(a).

59 Paragraphs 149.1(2)(a) and 149.1(3)(a), and subsection 149.1(1), definition of “related business.”

60 Subsection 149.1(1), definition of “related business.” The courts have suggested that the CRA’s rule of thumb that “substantially all” is 90 percent or more is an oversimplification: see, for example, Watts v. The Queen, 2004 DTC 3111 (TCC).

61 Code section 512. (This provision has been part of US tax law since 1950.) For more detail on the US tax treatment of business activities, see the texts cited in note 6 supra.

62 Code section 513(a).

63 Code section 512.

Under the new Canadian regime, the repercussions of carrying on an inappropriate business are quite severe. The applicable intermediate sanction is spelled out in new subsections 188.1(1) and (2): a penalty of 5 percent (or 100 percent, coupled with a one-year tax-receipting suspension, for a repeat infraction) of the charity's gross business revenue in that year. The imposition of the tax on gross revenue rather than income introduces an excessively punitive approach, raising the question of whether subsection 188.1(1) is a constitutionally suspect attempt to regulate conduct, rather than a permissible attempt to regulate tax exemption.  

The question of what constitutes a “related business” has perplexed Canadian charitable organizations for many years. The law on related business was first described by the Federal Court of Appeal in *Alberta Institute on Mental Retardation v. The Queen*. On one view of the decision, the court held that a business was “related” if it raised funds for a charity’s purposes. However, in *Earth Fund/Fond Pour la Terre v. MNR*, the Court of Appeal rejected the *Alberta Institute* destination-of-funds approach (but did not provide a principled replacement).  

After the *Earth Fund* decision, the CRA released the final version of *Charities Policy Statement CPS-019*, setting out its administrative policy on the related business requirement. In that policy, the CRA suggested that a charity found to be carrying on an unrelated business could avoid revocation by transferring the inappropriate business activity to a taxable subsidiary.  

We applaud the CRA’s approach to this issue, given the lack of guidance in Canadian case law. New subsection 188.1(1) can be applied consistently with CPS-019 if the CRA applies the new intermediate sanction only to charities that refuse to reorganize inappropriate business ventures. In the United States, a similar shifting of business interests to taxable subsidiaries has received indirect approval by virtue of section 512(b)(13) of the Code, which provides rules for determining when certain tax-deductible amounts, such as interest or rent, paid to the tax-exempt parent by the subsidiary, are taxed at the parent’s level as income from an unrelated trade or business.  

**Acquisition of Control of a Corporation by a Foundation**  
A foundation can face sanctions if it acquires control of a for-profit corporation. The meaning of “control” for the purpose of the charity tax exemption is spelled...
out in subsection 149.1(12): generally, a foundation is considered to control a corporation where the foundation (alone or together with non-arm’s-length persons) owns 50 percent or more of the corporation’s issued share capital, having full voting rights under all circumstances. However, if the foundation has not bought more than 5 percent of such shares and is given additional shares that increase its total holding to over 50 percent, it will not be considered to have acquired control of the corporation. 70

The sanction that will be applied to a charitable foundation that acquires control of a corporation is laid out in new subsection 188.1(3). The sanction that applies in these circumstances is a tax of 5 percent (or 100 percent for a repeat infraction) of the foundation’s dividends from the controlled corporation. It seems rather arbitrary that the sanction for controlling a corporation is a penalty tax tied to dividends paid. This sanction leaves open the possibility that a foundation can acquire control of a corporation and sell the company to realize a capital gain. Provided that the corporation does not declare a dividend while it is controlled by the foundation, it is possible that the foundation will never face sanctions for having acquired control of the corporation.

It is difficult to discern a policy rationale for the prohibition and even more difficult to understand the rationale of the dividend tax sanction. A more effective sanction might have been one tied to the value of a controlled corporation. For example, in the United States, section 4943 of the Code limits a private foundation’s ownership interest in a business enterprise, combined with the ownership interests of disqualified persons, to 20 percent of the total ownership interest. If a foundation exceeds this limit, it is subject to an excise tax of 5 percent of the value of the excess holdings until the holdings are reduced to appropriate levels. For amounts received by gift or bequest, the foundation has five years to dispose of the excess amounts before becoming liable for the tax. The statute and related Treasury regulations contained elaborate transitional rules for foundations that had excess business holdings at the time of passage of the law. 71

Undue Personal Benefit

Charitable foundations must be constituted and operated exclusively for charitable purposes. 72 Likewise, the income of a charitable foundation may not be payable to or otherwise available for the personal benefit of any proprietor, member, shareholder, trustee, or settlor that is not a charitable organization. All the resources of a

70 Subsection 149.1(12). It should be noted that this exception may not be available where provincial legislation, such as Ontario’s Charitable Gifts Act (RSO 1990, c. C.8), prevents a charity (including a foundation) from controlling a corporation, regardless of how the ownership interest is acquired.


72 Subsection 149.1(1), definition of “charitable foundation.”
charitable organization must be devoted to activities with a charitable purpose. The common law governing charitable trusts imposes similar requirements.

In order to give further effect to these existing prohibitions on private benefit, new subsection 188.1(4) provides that in the event that a registered charity is found to be conferring an “undue benefit” upon a person, the applicable intermediate sanction against the charity is a penalty of 105 percent (or 110 percent for a repeat infraction) of the amount of the undue benefit. For a repeat infraction, subsection 188.2(1) further requires the minister to suspend the charity’s receipting privileges (unless the undue benefit was a gift). As an aside, it is our view that this sanction rests on unsteady constitutional ground since it clearly seeks to regulate conduct and not simply tax exemption.

An undue benefit includes a gift (other than to a qualified donee) or a payment to a member, trustee, or significant donor, or a person not dealing at arm’s length with such a person. Amounts paid as reasonable remuneration for goods or services and gifts made in the course of charitable activity (unless the only reason for the beneficiary’s eligibility was a relationship with the charity) are excluded from the definition of an undue benefit. Some might suggest that an “advantage” as defined by proposed subsection 248(31) could also be an undue benefit. However, the undue benefit exception for “reasonable consideration or remuneration” should lay that suggestion to rest.

The definition of an undue benefit is aimed at a number of discrete scenarios. One situation that is caught is excessive salary for senior management. This is

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73 Subsection 149.1(1), definition of “charitable organization.” Vancouver Society of Immigrant and Visible Minority Women v. MNR, [1999] 1 SCR 10, addresses the relationship between charitable purposes and charitable activities.


75 Defined in subsection 188.1(5) as follows:

For the purposes of this Part, an undue benefit conferred on a person (referred to in this Part as the “beneficiary”) by a registered charity includes a disbursement by way of a gift or the amount of any part of the income, rights, property or resources of the charity that is paid, payable, assigned or otherwise made available for the personal benefit of any person who is a proprietor, member, shareholder, trustee or settlor of the charity, who has contributed or otherwise paid into the charity more than 50% of the capital of the charity, or who deals not at arm’s length with such a person or with the charity, as well as any benefit conferred on a beneficiary by another person, at the direction or with the consent of the charity, that would, if it were not conferred on the beneficiary, be an amount in respect of which the charity would have a right, but does not include a disbursement or benefit to the extent that it is

(a) an amount that is reasonable consideration or remuneration for property acquired by or services rendered to the charity;

(b) a gift made, or a benefit conferred, in the course of a charitable act in the ordinary course of the charitable activities carried on by the charity, unless it can reasonably be considered that the eligibility of the beneficiary for the benefit relates solely to the relationship of the beneficiary to the charity; or

(c) a gift to a qualified donee.
similar to the “reasonable compensation” requirement under section 4958 in the United States.\textsuperscript{76} While relatively few cases have been brought in the United States, as a precaution many large US charities that pay significant executive compensation now retain outside consultants to advise on the reasonableness of executive compensation.\textsuperscript{77} We expect that a similar approach will develop in Canada. The Canadian undue benefit sanction also encompasses excessive payments to non-arm’s-length fundraisers.

Grants to foreign charities may also be caught by the undue benefit definition. It has not been possible for a Canadian charitable organization to make foreign grants for many years.\textsuperscript{78} The CRA has devoted significant audit attention to this issue, particularly since September 11, 2001; indeed, it has gone so far as to revoke the registration of prominent charities for making grants to foreign charities.\textsuperscript{79} Given the CRA’s aggressiveness when revocation was the only available penalty, it appears that this will be an area where intermediate sanctions may be applied harshly by the CRA. It may even be possible (though perhaps unlikely)\textsuperscript{80} that the new undue benefit sanction could apply to a gift made to the religious school attended by a donor’s child.

In the United States, by contrast, private foundations (and public charities) are permitted to make grants to both foreign and domestic organizations, whether tax-exempt or not, as long as the grant-making foundation takes appropriate steps to ensure that the grant funds are used for a charitable purpose by the ultimate recipient. Failure to take appropriate steps results in an initial excise tax liability of 10 percent of the amount involved in the inappropriate grant, plus a requirement of correction.\textsuperscript{81} If timely correction does not occur, an excise tax of 100 percent of the amount involved is levied. Currently, publicly supported US charities are not subject to intermediate sanctions, and their overall tax-exempt status is jeopardized only when inappropriate grants or other activities become a substantial part of their activities.\textsuperscript{82}

\textsuperscript{76} As discussed in notes 35 and 36 and the accompanying text.


\textsuperscript{79} See Canadian Magen David Adom, supra note 55, and The Canadian Committee for the Tel Aviv Foundation v. The Queen, 2002 DTC 6843 (FCA).

\textsuperscript{80} Particularly given the decision of the Federal Court of Appeal in Woolner v. AG of Canada et al., 99 DTC 5722; [2000] 1 CTC 35.

\textsuperscript{81} Code section 4945.

Late Filing of Information Returns

Subsection 149.1(14) of the Act requires that an information return be filed annually by every charity. New subsection 188.1(6) introduces a penalty of $500 for failing to file, or late filing, the required return. Under the old rules, a registered charity had a grace period (administratively, at least) of a few months after the registration deadline in which to register its annual return; if it failed to do so, the CRA gave notice that its registration would be revoked.83 In the past, this was the most common way for a charity to lose its registered status. In order to have its registration reinstated, a charity would have to file its late returns as well as an entirely new application package. An application for reinstatement was treated as a new application and subjected to current CRA standards. Because these standards changed over time, it was not unusual for a charity to apply for reinstatement of registration only to discover that it was no longer eligible in accordance with the current standards.84

In the United States, the penalties for late filing are less severe (not revocation) but can be more expensive than those that apply in the Canadian regime. Generally, a US charity that files late is subject to a penalty of $20 per day for every day past the deadline, to a maximum of $10,000 or 5 percent of the charity’s gross receipts; however, if the gross receipts of the charity exceed $1 million, the penalty is $100 per day to a maximum of $50,000.85 These penalties apply not only to late returns but also to incomplete or inaccurate returns.

Issuing Incomplete Receipts

Regulation 3501 of the Income Tax Regulations requires registered charities to include the following information on their official receipts:

- the name, address, and registration number of the organization;
- the serial number of the receipt;
- the place the receipt was issued;
- the day the receipt was issued;
- the day or year a cash gift was received, or the day a non-cash gift was received, and a description of the gift;
- the name and address of the donor;
- the value of the property donated; and
- the name and address of the appraiser, if any.

83 Paragraph 168(1)(c).
84 This occurred, for example, in United Scottish Cultural Society v. CCRA, 2004 DTC 6660 (FCA), discussed in Susan M. Manwaring, “Care in the Registration Process Is Key to a Successful Registration Appeal” (2005) vol. 8, no. 3 Charitable Thoughts.
85 Code section 6652(c)(1)(A).
As well, proposed retroactive amendments designed to address the issuance of split receipts\(^{86}\) will require the following additional information to be included on official donation receipts:

- the “eligible amount” and the “advantage” received by the donor;\(^{87}\) and
- the name and Web site address of the CRA.\(^{88}\)

New subsections 188.1(7) and (8) apply a penalty of 5 percent (or 10 percent for a repeat infraction) of the eligible amount of the receipt if a registered charity issues a receipt that does not disclose all of the required information. This penalty seems unduly harsh for what may be no more than an insignificant clerical error.\(^{89}\) It would be preferable to limit the application of this sanction to the regular and deliberate issuance of incomplete receipts, particularly given that many questions of interpretation remain to be resolved with respect to the taxation of donors.

In the United States, in order to claim a deduction for a charitable contribution in calculating income tax, the donor must obtain a receipt from the donee charity.\(^{90}\) As under Canadian law, failure to obtain a receipt, regardless of which party is at fault, results in disallowance of the charitable contribution deduction claimed by the donor, rather than a penalty to the donee charity. However, in contrast to the Canadian rules, there is no specific US penalty for a donee charity that unintentionally issues an inaccurate receipt.

### Issuing False Receipts

Subsection 188.1(9) serves to reinforce the importance of issuing a valid receipt containing correct information for every charitable donation received by a registered charity. The following financial penalties apply to individuals as well as to registered charities that issue false receipts:

\(^{86}\) See proposed amendments to subsections 110.1(2) and 118.1(2) and new subsections 248(31) and (32) in Canada, Department of Finance, *Legislative Proposals Relating to Income Tax* (Ottawa: Department of Finance, July 2005). These amendments were included in draft legislation issued in December 2002 and December 2003, and re-released on July 18, 2005. These proposed amendments are designed to clarify that a charity may issue an official donation receipt even when a donor receives a benefit (or “advantage”) for making the donation. See Patrick J. Boyle, “Charitable Gifts: An Update,” in the 2004 Conference Report, supra note 44, 7:1-42, for a recent detailed analysis of the proposed (and still unlegislated) split-receipting rules.

\(^{87}\) The new requirements are to apply in respect of gifts made after December 20, 2002.

\(^{88}\) This requirement is to apply for receipts issued after 2004. For details, see Canada Revenue Agency, “New Requirements for Official Donation Receipts Questions and Answers” (online: http://www.cra-arc.gc.ca/tax/charities/jrt-e.html).

\(^{89}\) For an example of a donation tax credit claim being disallowed for a relatively minor infraction, see *Dupriez et al. v. The Queen*, 98 DTC 1790 (TCC).

\(^{90}\) Code section 170(f)(8).
- where the total eligible amounts of the false receipts for the year do not exceed $20,000, the sanction is a 125 percent tax on the eligible amount stated on the receipt; and
- where the total eligible amounts of the false receipts for the year exceed $20,000, the sanction is a 125 percent tax on the eligible amount stated on the receipt and a suspension of receipting privileges under subsection 188.2(1).

This penalty applies where a charity (or other person) knowingly, or in circumstances where it should have known, has issued a false receipt. It is similar in effect and in harshness to the section 163.2 civil penalties that apply to third-party tax advisers and preparers of tax returns or forms.91 Interestingly, subsection 188.1(10) provides that if both section 163.2 and subsection 188.1(9) apply, the person penalized will be liable only for the greater of the two penalties.

While it is reassuring that actual knowledge or culpable negligence is required in order for the sanction to apply, there are many relatively common situations where this sanction should be considered. For example, the sanction is likely intended to apply to receipts based on unsupported “art flip” valuations. It may also apply to charities issuing split receipts that do not properly identify and value the advantage to the donor.92 Another example might be a receipt issued to the wrong donor, such as a receipt in the name of a shareholder when the property donated is a corporate cheque.93

In the United States, if a charity collaborates in the creation of false documentation to support a charitable contribution deduction where none would otherwise exist, a potential civil penalty could apply under section 6701 of the Code, which relates to the aiding and abetting of the understatement of tax liability.94 The penalty is set at $1,000 per document. As is the case under the new Canadian law, for the penalty to apply, section 6701 requires actual or constructive knowledge that the document would be used to understate tax liability. Perhaps because of the


92 See Boyle, supra note 86.

93 For the CRA’s position on this issue, see Canada Revenue Agency, Charities Policy Commentary CPC-010, “Official Donation Receipt,” February 21, 1994. In essence, a charity may issue an individual receipt if it receives a representation that the cheque actually represents property of the individual (perhaps because the company cheque payable to the charity actually represents payment of a dividend to the shareholder).

high standard, very few cases have been reported in which the section 6701 penalty has been applied in a charity context.

**Intercharity Transfers To Delay Disbursement Quota Expenditures**

Subsection 188.1(11) addresses the situation in which two registered charities engage in a reciprocal gifting arrangement in order to delay spending amounts on charitable activities. In such an arrangement, two charities could transfer an amount back and forth in alternating years in order to meet their disbursement quota for the year in which the transfer is made. Charities that take this approach to disbursement quota compliance will be jointly and severally liable for a tax of 100 percent of the transferred amount. In addition to this sanction, the participating charities may be subject, as in the past, to revocation of their registration.95

In the United States, there is no specific distribution requirement for publicly supported charities; however, private foundations must, at minimum, annually expend funds for charitable purposes in an amount equivalent to 5 percent of their assets.96 This distribution can be made to a publicly supported charity or to another private foundation provided that the recipient private foundation pays out those amounts within the year in addition to meeting its own 5 percent payout requirement. If the 5 percent payout requirement is not met, an excise tax of 15 percent of the amount that should have been distributed is assessed. If correction is not made in a timely fashion, an additional tax of 100 percent of the amount that should have been distributed is assessed.

**Failure To Keep Proper Books and Records**

Subsection 230(2) of the Act sets out the record-keeping obligations of a registered charity as follows:97

Every registered charity and registered Canadian amateur athletic association shall keep records and books of account at an address in Canada recorded with the Minister or designated by the Minister containing

(a) information in such form as will enable the Minister to determine whether there are any grounds for the revocation of its registration under this Act;

(b) a duplicate of each receipt containing prescribed information for a donation received by it; and

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

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95 Subsection 149.1(4.1).
96 Code section 4942.
97 It has been suggested that an incorporated charity is also required to meet the general corporate record-keeping requirements of the Act. Since these obligations are overlapping and the general corporate obligations are inconsistent with the specific requirements of subsection 230(2), we do not believe that the Act should be interpreted as requiring dual compliance.
Paragraphs 230(2)(b) and (c) clearly require a charity to keep duplicate receipts and other donation records, but the scope of paragraph 230(2)(a) requires registered charities to exercise a great deal of discretion in assessing what information they are required to retain.\(^98\) It appears that a charity must keep records showing the charitable purposes of all activities; therefore, it is advisable that a charitable organization retain all records if it is concerned that certain activities may be perceived as not being for a charitable purpose. Pursuant to paragraph 168(1)(e), registration can be revoked for failure to keep proper records. Destruction of records in some circumstances could even be a criminal violation of the Act.\(^99\)

Paragraph 188.2(2)(a) creates a new sanction for a charity’s failure to retain adequate books and records: suspension of a charity’s receipting privileges for a year. This is a severe penalty considering the haziness of the requirement for record retention. Until there is substantial and detailed statutory (preferable) or administrative (at the least) clarification of the scope of record-keeping requirements for charities, a small monetary penalty would have been more sensible.

US charities must also keep adequate records and books to demonstrate compliance with the law.\(^100\) The sanction for failure to keep such records may be an excise or penalty tax or even revocation of tax-exempt status.

**Mechanics of the Intermediate Sanctions**

**Gifts To Avoid Suspension**

New paragraph 188.2(2)(b) imposes a sanction on a charity that helps another charity to avoid the effects of a suspension of receipting privileges by receiving a gift and transferring it to the suspended charity.\(^101\) The sanction is itself a suspension of receipting privileges.

This provision is unclear in its application and will result in uncertainty about just how it affects the fundraising and charitable activities of a suspended charity. For example, would this provision prohibit a charity from accepting gifts, holding them during another charity’s suspension, and then forwarding them after the suspension is lifted? Can a charity accept gifts on behalf of a suspended charity and then hire that charity as an agent to carry out activities that the suspended charity would have carried out before the suspension? The issues are even more difficult in the context of a parallel foundation that exists to support a particular operating

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99 Paragraph 239(1)(b). The penalty on summary conviction is a fine ($1,000-$25,000) and/or imprisonment (for a term not exceeding 12 months).

100 See Code section 6033 and Treas. reg. section 1.6001-1(c). For a recent discussion of the information that must be maintained and reported, see Jody Blazek, “A Variety of Issues Face Organizations That Face the 990 Forms” (2004) vol. 15 Taxation of Exempts 255-68.

101 We assume that donors (including granting charities) will be entitled as a matter of administrative law to assume that a charity listed as registered, without any specific notation, on the CRA’s Web site is not subject to a receipting suspension.
charity. How should a foundation handle the suspension of a charity it supports? Would the expectation that the gifts will eventually be granted to the operating charity cause the parallel foundation to be suspended as well?

In the United States, a publicly supported charity or a private foundation may use taxable organizations, including, theoretically, organizations that have lost their tax-exempt status, as conduits for charitable activities. The charity or private foundation must maintain adequate books and records to demonstrate that it has sufficient control over the ultimate use of its funds to ensure that they are applied only for charitable purposes. Provided that this requirement is met, it is possible for a charity to act as the recipient of gifts or funds that the donor intends to be used for the benefit of a charity that has lost its tax-exempt status.

**Repeat Offences**

If a particular offence is repeated within five years of the first penalty assessment, sanctions are increased for the subsequent offence. While the purpose of imposing a higher sanction for a repeat offence is obvious, five years seems an arbitrary period, as well as a long time in the life of a charity’s management group. A mandatory increase in sanctions for repeat offences will result in injustice in circumstances where there has been a change in management. It makes more sense to have a repeat offence sanction that is discretionary and imposed, as a matter of administrative practice, only if the management of the offending charity has not changed since the time of the first violation.

Furthermore, where the technical notes state that some of the sanctions are intended to apply to “unintended or incidental breaches of the Act,” the increase in penalty seems particularly harsh where the charity has exercised due diligence but, nevertheless, inadvertently fails to comply with one of the many requirements of the Act.

**Penalties in Excess of $1,000**

If a charity is subject to a penalty under the Act of more than $1,000 in a given year, the charity may pay all or part of the amount of the penalty to an “eligible donee” instead of remitting the entire penalty tax to the government. It appears likely that this innovation is a response to constitutional concerns raised earlier. To be an “eligible donee,” a Canadian registered charity must be compliant with the Act and more than 50 percent of its directors or trustees must deal at arm’s

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102 Code section 4945.
103 Subsection 188.1(2), paragraphs 188.1(3)(b) and (4)(b), and subsections 188.1(8) and 188.2(1).
104 Canada, Department of Finance, *Legislative Proposals, Draft Regulations and Explanatory Notes Relating to Income Tax* (Ottawa: Department of Finance, September 2004), 118.
105 See subsections 189(6.2) and (6.3). No such provision exists under US tax law.
106 As discussed above at notes 51 to 53 and the accompanying text, section 92(7) of the constitution gives legislative jurisdiction over charities to the provinces.
length with every director or trustee of the penalized charity. It is not clear how the option of paying the penalty tax to an eligible donee will apply to a penalized charity whose charitable purposes do not include making grants to other registered charities. It is likely that unless the penalized charity could quickly amend its purposes to add a granting power, it would be unable to avoid the penalty tax.

The directors or trustees of a charity subject to intermediate sanctions may have personal fiduciary liability exposure. Permitting or causing the charity to be exposed to a serious fine would likely be a breach of duty in many cases. On the other hand, if the fine can be met by a grant to another charity (a proper expenditure for the particular penalized charity), then it might well be argued that the charity has not been harmed by the imposition of the penalty.

Assessment

Unlike the US taxes described earlier, the Canadian intermediate sanctions are not imposed on a self-assessment basis. In essence, although subsection 188.1(1) refers to a charity that is subject to a Canadian intermediate sanction as being “liable to a penalty under this Part [emphasis added],” there is no provision in the Act that clearly mandates self-assessment of a section 188.1 penalty.

Revocation and Annulment

Above and beyond the intermediate sanctions discussed above, the Act still allows the CRA to revoke a charity’s registration for serious offences. According to the Department of Finance, both revocation and intermediate sanction taxes may be applied to the same charity for the same offence.

Under the US intermediate sanctions regime, the threshold at which revocation of tax-exempt status applies in lieu of, or in addition to, the imposition of the section 4958 excise tax has been stated only in the most general terms in the legislative history of the statute and not in the text of the rule itself. Essentially, Congress intended revocation to occur only when the excess benefit rises to the level where the organization no longer operates as a charitable organization. It is not clear as a matter of US tax law whether a single transaction is sufficient to jeopardize tax-exempt status or whether a series of inappropriate transactions is required.

The 2004 Canadian federal budget proposed to introduce an amendment that would allow the CRA to revoke a registration obtained on the basis of false or misleading information. This proposed rule was designed to enable the CRA to revoke the registration of a charity designed to serve as a “fundraising” vehicle for
abusive fundraisers. While the amendment was not included in the first version of the draft legislation (perhaps in response to criticism from practitioners who thought that the Act already provided adequate tools to deal with the situation), it was reintroduced in the Bill C-33 draft and subsequently enacted as new subparagraph 149.1(4.1)(c).

Revocation tax can no longer be avoided by making a payment to a “qualified donee,” such as a foreign university; now, revocation tax can be avoided only by making a grant to an “eligible donee” as defined above. Under the old compliance regime, revocation tax applied one year after revocation. In the event that the assets of the charity were stripped during that year, the CRA believed that it had no recourse. Accordingly, the Act now provides that the penalty tax is to be assessed immediately, while collection is suspended for one year. This allows the CRA to take steps to secure its position during the first year, by relying on the usual “jeopardy collection” measures.

The Act now provides the CRA with authority to annul a registration granted in error or where the charity ceases to be a charity solely because of a change in law. However, an official donation receipt issued prior to annulment will be accepted as valid. An annulment does not result in revocation tax or any other penalty. While the CRA has been proposing annulments as a way of settling revocation proposals on a consent basis for some time, its legal authority for pursuing this practice was perhaps questionable. The availability of annulment is helpful to the CRA in administering the Act because annulment provides a way of correcting errors without

111 Budget Plan, supra note 4, at 343.
112 See Hayhoe, supra note 44, at 186. However, it may be that the failure to include the amendment in the September 2004 legislative proposals was an oversight.
113 See subsections 188(1.1) and (1.3). The CRA is concerned about transfers to non-arm’s-length Canadian registered charities. (Indeed, in the past we have sometimes advised charities engaging in risky activities to pre-register a non-arm’s-length recipient charity in case the registration of the charity engaging in such activities was revoked: Hayhoe, supra note 78.) The CRA is also concerned about transfers to qualified donees that it is not able to regulate in any practical way—primarily foreign qualified donees, but also municipal governments and quasi-municipalities, such as native bands.
115 See subsections 188(1), (1.1), and (1.2).
116 See subsection 225.2(2). See Colin Campbell, Administration of Income Tax (Toronto: Carswell, 2003), 284-87, for more detail on jeopardy collection procedures.
117 Subsection 149.1(23).
118 Subsection 149.1(24).
119 In Canada Revenue Agency, Charities Summary Policy A23, “Annulment,” September 3, 2003, the CRA stated, “The Minister of National Revenue can annul a registered charity’s status when it has been registered in error. A charity that has been annulled is deemed never to have been registered and consequently, is not subject to revocation tax.”
the reputational damage to a charity that is associated with a revocation of registered status.\textsuperscript{120} 

Note that annulment and revocation are mutually exclusive in many circumstances. If a registered charity should never have been registered, then the organization cannot be said to have “ceased” to meet the requirements for registration (one of the conditions for revocation under subsection 168(1)).

**New Appeals System**\textsuperscript{121}

Under the old compliance regime, when a charity’s registration was revoked or an application for registration denied, the only recourse was an application for judicial review to the Federal Court of Appeal.\textsuperscript{122} There was no provision for an administrative appeal or objection process—a serious deficiency in the administration of the charity tax system. The recent legislative amendments have added an administrative objection process for registration and sanction matters.\textsuperscript{123} Registration appeals will continue to be addressed by Federal Court of Appeal judicial review,\textsuperscript{124} while appeals of intermediate sanctions will be dealt with in the first instance by trial in the Tax Court of Canada.\textsuperscript{125}

**Appeal Stays**

Revocation will continue to be proposed by notice.\textsuperscript{126} Once 30 days have passed from the issuance of the notice, the minister may revoke the charity’s registration.\textsuperscript{127} A charity’s right to appeal a proposed revocation crystallizes when notice is given. Typically, the CRA will not proceed with a revocation until any appeal to the Federal Court has been decided. If the CRA chooses to push forward to actual revocation in the face of a filed appeal, the Federal Court of Appeal may stay the revocation pending its decision.\textsuperscript{128}

If the CRA suspends a charity’s ability to issue official donation receipts, the Tax Court of Canada may, on application, postpone the suspension if it is “just and equitable to do so.”\textsuperscript{129} Postponement is available without even filing an appeal—apparently to allow a suspended charity to put its finances in order in the face of

\textsuperscript{120} Arthur B.C. Drache, *Canadian Taxation of Charities and Donations* (Toronto: Carswell) (looseleaf), 6-41 to 6-42.

\textsuperscript{121} The discussion that follows is based on Hayhoe, supra note 44. For more detail on changes to the appeals regime, see Manwaring and Hayhoe, supra note 44, at 8:24-25.

\textsuperscript{122} Subsection 172(3).

\textsuperscript{123} Subsection 168(4).

\textsuperscript{124} Subsection 172(3).

\textsuperscript{125} Subsection 189(8).

\textsuperscript{126} Subsection 168(1).

\textsuperscript{127} Subsection 168(2).

\textsuperscript{128} Federal Court Rules, 1998, SOR/98-106, as amended.

\textsuperscript{129} Subsections 188.2(4) and (5).
the likely drying up of its revenue. Postponement will also be important to allow the charity to figure out whether to appeal, because receipting suspensions begin only 7 days after the CRA mails a notice of suspension.\footnote{130} Obviously, this 7-day period is ridiculously short. Moreover, a suspension notice is important enough that it should be served, not just mailed. Even a 30-day period would allow a charity that has received a suspension notice to obtain advice. The shortness of the 7-day period means that it will typically be “just and equitable” for the Tax Court to grant a postponement (or perhaps two postponements: the first to allow the charity to obtain appeal advice and the second to prosecute the appeal).

The intermediate sanction taxes are subject to the usual collection stay pending appeal determination.\footnote{131} Even without an appeal (subject to the jeopardy collection rules), penalty taxes do not become collectible until the “collection commencement day”\footnote{132} —one year after the day the assessment notice was mailed.\footnote{133}

In the United States, proposed assessments of taxes—whether they are excise taxes or penalties, or income tax as a result of revocation of tax-exempt status—cannot be made final until the organization in question has been given the opportunity for an administrative appeal to the IRS.\footnote{134} The appeal may be directed to a special Appeals Division within the agency or to the headquarters if there is no precedent or guidance regarding the issue in question. The fact that a particular organization is availing itself of the internal appeal process is not made public. If the proposed assessment of tax is upheld in the administrative appeals process, the organization may challenge the action in court,\footnote{135} at which time the matter becomes public.

**CONCLUSION**

The new Canadian intermediate sanctions are generally in the public interest\footnote{136} and may go a long way toward clarifying the varying levels of tax compliance required from a charity. However, they do cause some concern: some of the sanctions are extremely harsh on their face, while others reflect both ambiguous drafting and a lack of clarity in the underlying policy. While we await guidance from the CRA and the courts on how the Canadian sanctions should be applied, the US experience with a similar compliance regime may well provide some useful guidance.

\footnote{130} Subsection 188.2(3).
\footnote{131} Subsection 225.1(2).
\footnote{132} Subsection 225.1(1).
\footnote{133} Subsection 225.1(1.1).
\footnote{134} Treas. reg. sections 601.103(c)(1) and 601.106(b). For more detail, see chapter 9 of Michael I. Saltzman, *IRS Practice and Procedure*, rev. 2d ed. (Valhalla, NY: Warren, Gorham & Lamont) (looseleaf).
\footnote{136} Leaving aside the issue, discussed above, of whether the federal government has constitutional authority to impose such sanctions.