



MEMORANDUM / NOTE DE SERVICE

Memo to the Minister or Minister's Staff

SECRET	
Originator/Telephone number	Auteur/Numéro de téléphone
Bill Murphy	996-6783
Our file	Notre référence
3140-003	
Your file	Votre référence
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Date	NOV 16 2011

Minister of Finance

- Minister's Office (Original + 7)
- DMO (4)
- Assoc. DM PR (1)
- Assoc. DM LL (1)
- ADM - EFP (1)
- ADM - C&C (1)
- ADM - Law (1)
- ADM - Tax Policy (3)
- General Director (2)
- GD - Tax Counsel (1)
- Director - ITP (1)
- ADM - FPRSP (1)
- Central Registry (1)
- A/Director (1)
- Diary (1)
- Originator (1)
- Chief (1)
- File (1)

FROM / DE

Michael Horgan

s.19(1)

SUBJECT / OBJET

Upcoming Phone Call with

Regarding the Regulation of Charities

For information. To be read before your phone call on November 22 with

would like to talk about the proportion of charitable funding which goes to the operating costs of charities rather than their charitable activities. She would like to ensure that most funds raised by charities "go to the cause". This note summarizes the current rules on permissible fundraising and administrative costs. Suggested key messages are included for use in your conversation.

Background

Under the Constitution, the regulation of most aspects of a charity's operations falls within provincial jurisdiction. Charities are subject to provincial requirements with respect to fundraising and other aspects of their operations. A number of provinces, for example Alberta and Saskatchewan, have specific legislation to address fundraising by or on behalf of charities, including the requirement that fundraising companies be licensed with the province.

In practice, the Canada Revenue Agency (CRA) plays a key role in regulating charities due to the generous tax assistance provided for donations. To be eligible to issue official donation receipts, an organization must be registered with the CRA, must be established and operated exclusively for charitable purposes, and must abide by certain other regulatory rules contained in the *Income Tax Act* (ITA).

The ITA and common law relating to charities generally require a charity to devote all of its resources to charitable activities. Charities are, nonetheless, permitted to spend amounts on overhead, such as management, administration and fundraising provided that these are reasonable in the circumstances and proportionate to the amounts being spent on charitable activity.

Sean Keenan (996-8267)

FIN 205-0021 (2011/02)

Canada

The determination of whether a charity is operating in compliance with the ITA must be done on a case-by-case basis, taking into account the particular circumstances of the charity. The CRA conducts audits of approximately 800 registered charities each year to verify compliance including whether they are devoting appropriate amounts of resources to charitable activity. Where the CRA discovers problems, it has a variety of tools to enforce compliance including imposing monetary sanctions, temporarily suspending the receipting privileges of a charity, or revoking its registered status.

Recent changes

Disbursement Quota Reform

Up until 2010, the ITA contained a particular formula known as the disbursement quota (DQ) which annually required a charity to expend a certain amount on direct program related activity as opposed to “non-charitable” expenditures such as management, administration and fundraising. The DQ had two components. It required that each year a charity’s spending on charitable activities (including gifts to qualified donees) be at least:

1. 80 per cent of the previous year’s tax-receipted donations (i.e., a “charitable expenditure rule”); and,
2. 3.5 per cent of all assets not currently used in charitable programs (e.g., endowments) if these assets exceed \$25,000 (i.e., an “anti-capital accumulation rule”).

As a regulatory tool to limit non-charitable expenditures, the DQ suffered from a number of deficiencies:

- The DQ was an incomplete measure that focused on a partial set of revenue sources (i.e., tax receipted donations). It thereby disproportionately affected small, donation-reliant charities and was ineffective at regulating larger charities with diverse revenue sources.
 - The DQ was complex and difficult to understand. In order to accommodate the wide variety of circumstances faced by charities, the DQ contained a number of exceptions and special rules. These rules added considerable complexity and, as a result, the DQ was difficult to calculate and was misunderstood by most charities.
 - The nature of a “charitable” expenditure is at best ambiguous. Defining which expenditures are directly expended on charitable programs versus those which would constitute an expenditure on overhead is often difficult. For example, a salary paid to a manager at a charity may, in certain cases, be clearly administrative, but this may be less clear when that individual is directly supervising the delivery of services to the public.
 - The DQ was rarely used by the CRA as a compliance tool. The CRA generally focuses its compliance activities on cases of serious abuse and, in such circumstances, the DQ was unnecessary for the purposes of pursuing compliance action – i.e., other legislative and common law rules were more effective (as described below).
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More generally, while commonly relied on by the public, a simple comparison of the proportion of charitable expenditures to overhead costs often leads to imprecise results.

- Such a comparison often ignores the nature of activities a charity engages in to raise revenues. For example, a charity that has a related business¹ will often have high fundraising expenditures (associated with the cost of operating the business), and proportionately lower charitable expenditures, as these are conducted based on the profits earned.
- Charities often have uneven expenditure patterns, such as when a program is in a start-up phase. As such, while expenditures on overhead will increase in these years, it is often necessary to look at a charity's expenditures over a longer period of time.

Accordingly, in Budget 2010 the Government responded to calls from many stakeholders in the charitable sector to reduce the administrative burden on charities by removing the charitable expenditure component of the DQ.



CRA Guidance on Fundraising

s.21(1)(a)

Several years ago, the CRA expanded the guidance it provides to the charitable sector and the public on the issue of acceptable fundraising practices. The guidance makes clear that charities must ensure that fundraising expenditures are reasonable and proportionate:

- If the ratio of fundraising costs to charitable expenditures is under 35 per cent, it is unlikely to generate concern.
- Where the ratio is between 35 and 70 per cent, the CRA would examine the average ratio over recent years and might require a more detailed assessment of expenditures.
- A ratio over 70 per cent would alert the CRA to potential abuse. In this case, the CRA could use intermediate sanctions such as a monetary penalty or suspension of the charity's tax-receipting privileges (as described in the section below).

The fundraising guidance also provides a number of other factors which are relevant in determining whether a charity is operating in an appropriate manner, such as whether it is following certain best practices (for example, avoiding sole-sourced contracts).

¹ Under the ITA, charities are permitted to engage in business activities, provided that these are related to the achievement of their charitable purposes or a natural off-shoot of these purposes. This might include, for example, a business that provided on-the-job training to the hard to employ or a church that operated a religious book store.

Intermediate Sanctions

In recent years, the CRA has been given additional compliance tools to ensure charities are using their resources appropriately.

Since 2004, any charity which provides an undue benefit to any person may be subject to a monetary penalty of 105 per cent of the benefit provided², or may have its tax receipting privileges suspended for up to one year. A charity may be considered to be providing an undue benefit if, for example, it pays above-market salaries to any individual, or enters into an inappropriate contract with a professional fundraiser.

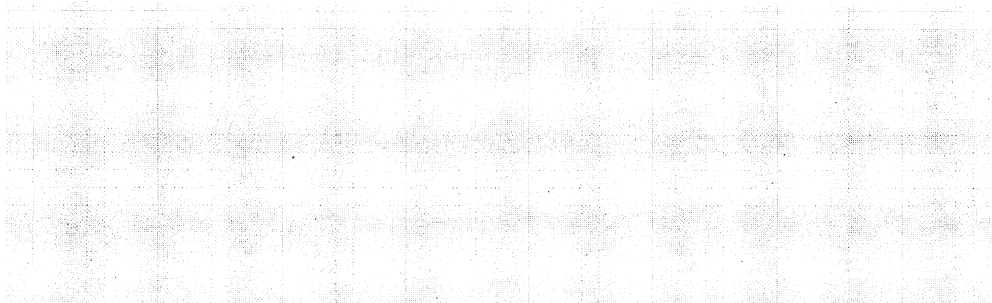
In addition, the CRA may revoke the registration of any charity which fails to devote sufficient resources to charitable activities. Any charity whose registration is revoked loses its right to issue official donation receipts and must disburse its assets to other registered charities within one year.

Enhanced public transparency

Registered charities are also required to annually file information returns with the CRA that contain detailed information about their activities – including disclosure of amounts spent on fundraising and paid to contracted fundraisers. To enable donors to determine whether an organization is expending its resources in an appropriate manner, this information is published on the website of the CRA.

Further, since 2009, the CRA has required charities to report on the salaries of their ten most highly compensated employees. This provides more transparency around appropriate compensation levels at registered charities.

Summary



s.19(1)
s.21(1)(a)

² The penalty is increased to 110 per cent for a repeat offence within five years.

Key Messages

- The *Income Tax Act* contains rules that require registered charities to devote their resources to charitable activities.
- The CRA is responsible for administering the law – which includes auditing registered charities to ensure that they are devoting their resources in an appropriate manner.
- The CRA audits approximately 800 charities each year to verify their compliance with the law.
- While most charities will have administrative and fundraising costs, these costs must remain reasonable and proportionate.
- The CRA recently enhanced its guidance with respect to charities on acceptable fundraising practices.
- Charities may be subject to monetary penalties or have their registration suspended if they provide an undue benefit to any person.
- They may also be de-registered for serious non-compliance, including failure to devote their resources to sufficient charitable activity.
- To enable donors to ensure that a charity is operating properly and for purposes they wish to support, registered charities are also required to annually file information returns with the CRA that contain detailed information about their activities - including disclosure of amounts spent on fundraising and paid to contracted fundraisers. This information is publicly available on the CRA website.

If concerns are raised about the elimination of the charitable expenditure portion of the DQ:

- The disbursement quota reforms announced in Budget 2010 responded to calls from many stakeholders in the charitable sector to reduce the administrative burden on charities, so they may devote more of their time and resources to charitable activities.

- **Eliminating part of the disbursement quota rule will not compromise the willingness of Canadians to give generously to charities because the CRA has other, more effective tools to ensure that charities devote their resources to their charitable purposes.**
- **In recent years, the CRA's ability to ensure that a charity's fundraising and other practices are appropriate has been strengthened by new legislative and administrative compliance measures and the provision of additional resources.**