

## Hands Across the Border: Working with Canadian Charities

Seth Perlman spoke with solicitor Lucinda Main of Beard Winter LLP, a Toronto, Ontario law firm. Beard Winter is familiar with the unique corporate governance and structural issues related to the operation of nonprofit entities and charities. They discussed how charities are regulated in Canada and what U.S. nonprofits need to know when considering cross border collaboration.

*Seth Perlman (SP):* How do you go about setting up a nonprofit entity in Canada? Who regulates charities?

*Lucinda Main (LM):* The Canadian Revenue Authority, or CRA, Canada's federal tax authority is responsible for overseeing tax-exempt entities. The subdivision known as the Charities Directorate carries out registration, compliance, information and planning. All organizations seeking charitable status designation must apply to the CRA.

To be granted charitable status, an organization must have a formal structure and a clear purpose. There are three types: a trust, a group with a formal written constitution, and a not-for-profit, formally known as a non-share corporation. The vast majority of applicants are not-for-profits. NFPs are corporations in most respects but instead of shareholders they are comprised of members who can only be individuals and are prohibited from receiving any pecuniary gain. There must be at least three members who also serve as the initial directors of the not-for-profit. The head office must be located in Canada.

The purpose of the company cannot be for profit and it must carry on a charitable activity, which is broadly defined.

To qualify for tax-exempt status and be allowed to issue charitable receipts, an organization must show that it is established and operates for charitable purposes only. There are four categories of charitable purpose: the relief of poverty; the advancement of education, the advancement of religion; and any other purposes benefitting the community which have previously been accepted by the courts.

The entity must meet the public benefit test demonstrating that it will serve all or a very significant portion of the public.

Finally, the applicant is required to provide a description of its decision-making process, a plan for generating income, and outline its anticipated expenses.

The process takes anywhere from two to twelve months, depending on the readiness of the organizers.

*SP:* Are registered charities exempt from sales tax or do they receive rebates?

*LM:* (For the most part, charities do not have to charge and collect sales tax on the service of supplies. Not all charities have to register for sales tax purposes.) They may be entitled to claim a rebate on the

provincial portion of harmonized sales tax - HST (a combination of federal goods and services tax – GST- and the provincial sales tax) paid or payable.

*SP:* If an organization receives most of its funding from the public, is it treated differently from an organization funded by a single or a few individuals?

*LM:* Under the Income Tax Act, the CRA will designate an applicant as a charitable organization, a public foundation or a private foundation. A charitable organization may spend up to 50% of its income in making gifts to qualified donees, which include other registered charities. In addition, less than half of its directors or trustees may be related, and at least half of its funds must be received from unrelated persons. In contrast, a public foundation must give more than half of its income to qualified donees, typically other registered charities. Like a charitable organization, not more than half of its directors or trustees may be related and both types of organizations may carry out their own activities. But a private foundation, although it may carry on its own activities like the other two, has no limitations on where it gets its funding or on how it is controlled. All the directors may be related, as may be the persons providing funding. None of the three may carry on unrelated business; charitable organizations and public foundations may carry on related business.

*SP:* What is the regulatory framework for the three types of organizations you just described?

*LM:* The general framework for all organizations seeking charitable status is the Federal Income Tax Act. Other laws might apply on a federal or provincial level relating to operations such as for a nursing home, school, or housing project. Here in Ontario we have the Charities Accounting Act that deals with several different issues respecting charity law.

*SP:* Are there any kind of annual registration requirements on the federal or provincial level?

*LM:* All entities must file an annual income tax return, and a not-for-profit must keep up its regular corporate filings with the jurisdiction of incorporation. But there is no requirement for an organization based in one province to register in another when it seeks donations there. An Ontario organization may freely seek funds in Manitoba. If it wants to conduct business there, however, it is required to register in that province.

*SP:* If a U.S. Corporation wants to raise funds in Canada, should they set up a Canadian entity if they want the contributions to be tax deductible?

*LM:* They may, but since only individuals may set up such an entity, you could not have an American charity or American company as a member of a not-for-profit in Canada.

*SP:* Is there a requirement that at least one member of the board be a Canadian citizen?

*LM:* At the federal level, the rules relating to residency are the same as those applying to for-profit corporations: at least 25% of the applicants of a not-for-profit must be residents of Canada.

*SP:* How does Canada regulate the solicitation of funds by a foreign charity?

*LM:* Any entity may solicit funds, but Canadians are warned to be prudent as to whom they give their donation. Very few foreign entities and organizations are eligible to issue official donation receipts. A qualified donee is limited to registered charities, the government of Canada, the U.N. and its agencies, Canadian universities that operate abroad, or any charity that the Canadian government has made a donation to. Very few foreign organizations can meet these criteria.

*SP:* Are there restrictions on Canadian organizations making donations to U.S. charities?

*LM:* Under the Double Taxation Prevention Treaty with the U.S., Canadian individuals and organizations may make donations to American charities and receive exemption, but only on their U.S. sourced income. If they have no such income, there is no Canadian tax credit.

*SP:* Is there any way a Canadian foundation can make a tax-deductible grant to an entity outside of Canada?

*LM:* The most common way to get tax credit for work done abroad is by donating to a Canadian tax-exempt entity that has a relationship with an intermediary, such as a joint venture, a contractor, an agent or a cooperative.

*SP:* Is the Canadian entity required to prove that the intermediary actually carried out the work?

*LM:* There are no hard and fast rules regarding intermediaries, its very fact dependent. The CRA has published guidelines on eligible structures. For example, in the case of a joint venture they look at several factors such as how many members of the Canadian board sit on the joint venture board, if the Canadian members sign contracts, if their funds are actually being used and anything similar that proves the Canadian entity is truly involved.

*SP:* Let's say an organization in Canada wants to make a donation to a group doing the kind of work they want to fund in Haiti. Can they?

*LM:* To give money or other gifts, it must be a qualified donee.

*SP:* If the Canadian Red Cross wants to fund a program in Haiti, not being carried out by them but by another organization...?

*LM:* They'd have to be involved in some way – either they have their own people on the ground or they have a joint venture with a Haitian charity or other organization. The Canadian entity must show that it is using its resources to carry out the kind of activities it has been approved for. Alternately, it could hire an agent in Haiti or make a contract with someone there to supply goods or services. For example, the agent arranges for donations of clothing and food, and it qualifies because the relief of poverty is part of the stated purpose of the Canadian charity. But it is essential that the Canadian organization retain control over its resources and be able to influence how the work is carried out.

*SP:* So a Canadian organization that wants to support, say, the Wyclef Jean Foundation, can't just send them money?

*LM:* That's correct, if it's not a qualified donee as we discussed earlier.

*SP:* Can a Canadian company engage in a profit-making activity? Does Canada have a version of the UBIT (unrelated business income tax) we have in the States?

*LM:* Our income tax act prohibits unrelated business activities and it will tax the profits of any such activity and impose penalties. As I mentioned earlier, both charitable organizations and public foundations are permitted to carry on related business activities. What is and is not related business is not spelled out in the Act; instead we rely on court case and the publications and guidelines issued by the CRA.

*SP:* What are the penalties for engaging in unrelated business?

*LM:* In the first instance, the CRA will charge a 5% penalty on the gross unrelated business revenue earned in a taxation year. A second infraction results in a 100% penalty and a one-year suspension for the charity to issue tax receipts. The CRA also retains the right to permanently revoke the tax-exempt status of a non-compliant organization. But a charity may first be given the opportunity to wind-up the unrelated business or spin it off into a distinct taxable entity to become compliant.

*SP:* Can the Museum of Ottawa, for example, run a gift shop or a restaurant? Is that considered a related business?

*LM:* If the gift shop is run by volunteers and is not the main activity of the museum but is subordinate to it, then it would be allowed.

*SP:* Can a charitable organization or not-for-profit lease space to an unrelated for-profit venture in exchange for consideration or a pledged donation? Could a zoo, for example, lease space to a restaurant?

*LM:* The running of a restaurant at a zoo or receiving lease payments from a restaurant on the zoo's premises may be deemed as related business. In addition, there are no prohibitions in the Income Tax Act against not-for-profit and/or registered charities conducting profitable activities through a wholly owned subsidiary. The subsidiary may pay the parent dividends with after tax dollars. The charity or not-for-profit would not lose its tax-exempt status in doing so.

*SP:* How are professional fundraisers regulated in Canada?

*LM:* The CRA has published guidelines – CPS 028 is the main federal regulation although some provincial ones also exist. The guidelines state that fundraising expenses are not considered to be charitable, and an organization may not spend a great deal of time and resources on fundraising.

Fundraising expenditures include all costs related to any activity that includes the solicitation of support, or that is undertaken as part of planning and preparing for future solicitations of support. It does not include asking for government funding.

The solicitation of support includes the request by a registered charity or someone on behalf of the charity for financial or in-kind donations. It also includes marketing or the sale of goods or services not within the charities own program but sold specifically to fundraise, even if no receipt is issued.

*SP:* How does the government determine if an activity is undertaken for the solicitation of support?

*LM:* There are two tests to determine if an activity was undertaken without the solicitation of support.

The first, the “substantially-all test”, asks if all (90% or more) of the objective was to advance the fundraising objective.

The second is a four-part test. They are: was the main objective fundraising? Did the activity include ongoing or repeated requests? Was the audience selected because of its ability to give? Was a commission-based revenue or compensation derived from a number or amount of donations? The answers to all questions must be no otherwise the charity must allocate a portion of costs as non-fundraising expenditures and a portion as fundraising expenditures.

If the ratio of costs to revenue raised is less than 35%, the CRA is unlikely to question or raise concerns. If they are greater than 35%, the CRA will examine past returns and look for a trend of high fundraising expenditures and may or may not do anything. When it’s greater than 70%, the CRA will further investigate and require the charity to provide a rationale for that level of expenditure. Again, the CRA has the power to revoke the charitable status designation. The issue of the cost of charitable fundraising is heating up in the media, and this puts some pressure on the CRA to follow through with its investigations.

*SP:* Does the CRA take into account fledgling organizations that would naturally have a higher ratio of fundraising to operating expenses in their first years of operations?

*LM:* It all depends if it raises a red flag with them - the rules are informal. They may just ask for an explanation and it could be a total non-issue.

*SP:* The fundraising expenses get reported annually?

*LM:* Yes, on the T-3010 form attached to the income tax return.

*SP:* That’s equivalent to our 990 form. Getting back to how a U.S. charity might collaborate with a Canadian one - could you elaborate?

*LM:* If they want to pool resources they’d likely set up a joint venture. There must be a common charitable agreed-upon objective. The terms of their written agreement should include the resources each contributes, a description of the decision-making process, etc. The CRA acknowledges that joint

venture agreements are peculiar and evaluating them is therefore fact specific. However, the Canadian entity must not completely rely on the foreign partner to carry out the charitable work if it is to qualify.

The decision-making board must include members of the Canadian charity. The CRA, if it investigates, will require proof that the Canadian partner has a say in the decisions and Board membership is a good indicator of that. Control over resources is another factor in determining Canadian involvement. If there appears to be a lack of control, the CRA may take the position that it's failing to carry out its own activities and in a worst case scenario could revoke the charitable registration.

The CRA has established some guidance on acceptable joint venture arrangements with foreign charities or other organizations. They look to see if the charity has actually volunteered on the ground wherever the charitable work is being carried out, if Canadian members have signed contracts, loan documents and other similar instruments, if they review and approve the annual budget. No one factor is more or less important than the other, and depending on the circumstances they carry different weight in the CRA's determination if it is a legitimate charitable joint venture.

*SP:* Does the CRA regulate what we call cause-related marketing or commercial co-venturing? For example, if a major corporation sells shampoo and they advertise on their bottle that the company will make a contribution to a Canadian charity (Red Cross) of ten cents for every purchase?

*LM:* It does certainly happen here! There are currently no regulations, documents or laws pertaining to the advertisement of products wherein a portion of the sale price is donated to charity. They are still regulated by truth-in-advertising laws, of course.