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The Problems with Direction and Control

By John Lorinc

This article is the second in a series on Canadian Charities Working Internationally.

ABSTRACT: Canadian charities working internationally are subject to regulations that are intended to boost accountability and ensure that charitable dollars flow to genuinely charitable activity. Recently the Canada Revenue Agency has stepped up audits of these same charities. Increased accountability demands are placing an administrative burden on charities working internationally, particularly those that are small and have few, if any, staff. Some argue that the system works just fine, while others would like to see change and point to both the U.S. and the U.K., both of which are more flexible than CRA.

RESUME: Les organismes de bienfaisance canadiens qui travaillent à l'étranger sont soumis à des règlements visant à renforcer l'obligation de rendre compte et à faire en sorte que les dons de bienfaisance servent réellement aux œuvres caritatives. Récemment, l'Agence du revenu du Canada (ARC) a intensifié les vérifications auprès de ces organismes de bienfaisance. Les exigences accrues en matière de reddition de comptes représentent un fardeau administratif pour les organismes de bienfaisance qui travaillent à l'étranger, particulièrement pour ceux d'entre eux qui sont de petite taille et qui n'ont que peu ou pas d'employés. D'aucuns soutiennent que le système fonctionne très bien, tandis que d'autres aimeraient qu'on apporte des modifications en citant en exemple les États-Unis et le Royaume-Uni, qui font preuve de plus de souplesse que l'ARC.

In recent years, Food for the Hungry Canada (FH Canada), a Christian non-profit aid group based in Chilliwack, British Columbia, has focused on an international program it calls "child focused community transformation" as part of its relief efforts. The group has operations in nine countries in Latin America, Asia and Africa. It is also part of a consortium of other Christian anti-hunger charities, LeSEA Global Feed the Hungry, which has offices around the world, including a large 501(c)(3) U.S. non-profit.

The Canadian operation has been successful in raising funds, bringing in \$6.6 million in fiscal 2013. LeSEA, by contrast, recorded revenues of \$12.8 million during the same year. But LeSEA's administrative expenses account for just 1% of its spending, which allows the group to spend 93 cents of every dollar raised on its global programs. FH Canada's administrative overhead eats up over 7% of its revenues, and so the group is only able to invest about 82 cents into its aid efforts.

To an outside observer, it may seem as if LeSEA is just a more efficiently managed non-profit, one that knows how to squeeze the most out of its donors' dollars. But as many Canadians working for internationally focused charities know all too well, there are subtle structural reasons that tend to drive up the administrative costs of running such organizations. Most of these have to do with adhering to what critics say is an unnecessarily stringent financial reporting regulatory framework that is something of an outlier by international standards.

To satisfy auditors at the Canada Revenue Agency (CRA), FH Canada must pay close attention to a pair of phrases in CRA's guidance to registered charities: "direction and control" and "own activities." If a Canadian charity is sending money overseas to some kind of undertaking – e.g., building a well, distributing food aid, etc. – it has to be able to prove it exercises "direction and control" over the project and that the project represents, in a meaningful way, the charity's own activity.

For Karen Koster, FH Canada's senior accountant and program director, those guidelines – laid out in a 2010 CRA guidance – means she has to gather budgets, receipts, activity plans, and quarterly variance reports from field officials. She also has to be able to prove that the charity has ongoing involvement with the aid program. "Honestly," she says, "a lot of this stuff wasn't on our radar" until eight years ago, when FH Canada officials were notified they would be audited. After the scrutiny, they received an "education letter" from CRA, which re-audited the group two years ago as a follow up.

"It's putting our administrative costs up," Koster says, noting that FH Canada had to hire a part-time employee to make sure CRA's extensive paperwork requirements are satisfied. She feels the regulatory hoops give donors more confidence in what FH Canada does. But she's also acutely aware of the fact that the U.S. sister organization doesn't have to worry about such rules, with the result that it has more flexibility in deploying its resources internationally than FH Canada does. "It definitely does hamper some of the activity we can do."

In Koster's view, there's a trade-off embedded in the regulatory and judicial framework that imposes the "direction and control" edict on charities with foreign activities. Canadian charities have to work harder to ensure that the money they're transferring overseas finds its way to a genuinely charitable activity, one that corresponds to the promises that charities make to their donors. The related point is that these funds, because they are tax exempt, deserve additional scrutiny because there's an indirect public cost in the form of foregone tax revenue.

The policy framework – which includes the relevant provisions of the *Income Tax Act* and CRA's 2010 guidance – turns on a handful of key court rulings, including a 2006 Federal Court of Appeal decision in the case of a Canadian Jewish aid charity that transferred funds to an Israeli group – both organizations are called Bayit Lepletot – that runs orphanages. The Canadian group hired an Israeli rabbi as its agent, to take charge of the work and handle the funds. But the court upheld a CRA decision and ruled that the Canadian charity couldn't demonstrate it had direction and control over the Israeli operation, despite the fact that the two groups appeared to be related. "It is not sufficient to show that

the agent is part of another charitable organization which carries on a charitable program.”

Despite such rulings, the system “seems to be working fine for charities,” says lawyer Mark Blumberg, who points out that Canadian charities have boosted the dollar value of their foreign operations to \$3 billion in recent years. “I know there are a lot of people who complain about the rules but I’d get back to basics: what if the rules didn’t exist? What then?”

Other experts in the charity regulations sharply disagree and argue that the “direction and control” language represents an unnecessary extra layer of paperwork, and serves to limit what Canadian charities are willing to do overseas. “I accept that there should be some regulatory oversight,” says tax lawyer Robert Hayhoe, a partner at Miller Thomson who represents many domestic and international charities and non-profits. “But ‘direction and control/own activities’ is a poor way of doing that.”

Yet the federal government has wielded those exact provisions ever more aggressively in the past few years, a period that has seen an uptick of audit activity aimed at the political activities of Canadian environmental charities, as well as the off-shore operations of internationally focused groups. Last summer, the Canadian Coalition for International Cooperation, a coalition of 70 Canadian charities with overseas operations, launched a bid to persuade the Harper government to dial back an aggressive stance that has led to more audits and warnings, including an admonition directed at Oxfam Canada about its goal of preventing poverty.

“The situation is negative and it’s very worrying,” Julia Sanchez, executive director of the council, told the CBC in August. “On a number of fronts, the charitable sector is trying to understand CRA’s intent,” adds Imagine Canada president and CEO Bruce MacDonald. “In some cases, the lack of clarity is challenging.”

The stepped-up vigilance has translated into onerous administrative demands, especially for smaller charities with few or no full-time staff. The CBC cited the case of CoDevelopment Canada, a B.C. charity that was told to translate all its documents and receipts, including taxi chits, from foreign operations from Spanish into English or French. Sanchez said such requirements impose a “huge amount of work” on charity staff.

But the consequences clearly go beyond burdensome overheads. Koster says FH Canada has turned down requests to participate in some “very viable” international programs managed by organizations outside the Feed the Hungry umbrella consortium because they weren’t sure they could meet the CRA requirements.

Other charitable sector advisors confirm that Koster’s experience is by no means anomalous (several charities contacted for this article declined to discuss their experiences). “Many charities have said that the CRA rules mean they can’t do overseas work,” says charities lawyer W. Laird Hunter, Q.C., a partner with Richards Hunter Toogood in Edmonton. He and others cite three key Federal Court of Appeal precedents decided in the early 2000s upheld CRA de-registration decisions involving Canadian charities that tried to work internationally and couldn’t provide documentation that demonstrated direction and control.

The rules, experts say, create a range of logistical roadblocks, depending on the type of overseas work. Hunter offers the example of a charity working on a small project in Africa. The group may have a reliable local agent who is a long-term volunteer and can do the work. But the volunteer may not have a

bank account, which could disqualify the individual from receiving funds. “Should that stop the process?”

At the other end of the spectrum, a larger Canadian charity may want to contribute to a complex international undertaking involving groups that are non-qualified donees – for example, donating funds to a renowned non-profit hospital to support a specialized type of surgical procedure. In practical terms, the Canadian charity would have to be able to show that it is exercising actual control over the use of the funds – for example, leasing the operating room, paying surgeons, and so on. Hunter points out that it’s very difficult for charities to document and then monitor those kinds of arrangements with an eye to proving to CRA that there’s a guaranteed outcome. “There’s a level of uncertainty.”

With large charities participating in international consortia on a broader projects, says Hayhoe, the Canadian partner must try to carve out a portion of the undertaking that it can oversee directly instead of merely pooling its funds. “It’s a work around,” he observes. The cost isn’t just additional administrative overhead: the consortia may have other members with more experience managing a particular type of project. But if the Canadian charity wants to participate, the organization’s officials have to show CRA that it has kept “its oars in the water,” Hayhoe adds.

Heather Evans, Deloitte Canada’s national managing partner for tax, says that clearly documented agreements between domestic charities and the foreign agents carrying out work on their behalf is “absolutely best practice.” But she’s had clients operating in volatile, fluid situations in countries with hobbled legal systems where it’s almost impossible to enforce contracts.

Evans mentions the example of a client that wanted to donate engineering and contracting services to help repair damaged water infrastructure following a natural disaster. Time, she says, was very much a factor: the charity wanted to move quickly and help flood victims whose lives were in peril. The group had connections to trusted local agents, but it didn’t have time, as she says, “to get bogged down with documentation.” In such cases, the charity needs to demonstrate after the fact that resources were used properly with positive outcomes. With this client, Evans says, CRA did an audit and the charity was able to answer credibly, so the story ended well.

FH Canada, for its part, has evolved its own approach to addressing the direction and control rule, one that relies on Koster having real time access to the financial reporting systems of the other members of the FH consortia. All the country organizations use the same system, and she’s able to retrieve variance analyses and field reports. She also lets the field staff know that she’ll conduct a random audit of project receipts a couple of times a year, so they know they need to be prepared to produce receipts and other documentation demonstrating how money is being spent.

Koster says the CRA requirement that the Canadian office have all receipts, records, and books pertaining to an overseas project is “not reasonable.” Such rules, if adhered to strictly, would require a huge effort on the part of field staff to separate out the Canadian expenditures from those of the other FH members. “They’ve got too much to do already.”

Based on CRA’s response to FH Canada’s systems during a couple of audits,

the accountability system Koster and her team have developed seems to pass muster. But she’s aware that a different auditor might see things differently. So FH Canada is permanently on tenterhooks. “It would be good if the CRA could be more specific about what we need to be doing to satisfy these

requirements,” she notes. “Are we over-doing it? We really don’t know. Could we be getting away with less? We don’t want to take that risk.”

As he considers the tense relationship between the federal government and the charitable sector, Imagine Canada president Bruce MacDonald argues that Ottawa needs to find a way to think more broadly about the economic role of philanthropic organizations, but it also has to alight on a regulatory environment that encourages social entrepreneurship and a measure of risk-taking. At present, he says, “if you try something and it doesn’t work, you can pull the whole organization down [i.e., risk de-registration].”

Mark Blumberg argues that the Canadian system provides the necessary safeguards and oversight, and those record-keeping standards, he adds, are necessary to deal with charities that abuse their tax-exempt status. “It’s not that every piece of paper has to be in Canada, but enough that CRA can determine whether the money is well spent.”

But experts like Laird Hunter and Robert Hayhoe point to the tax rules in jurisdictions like the U.S. and the U.K., which allow charities to transfer funds to off-shore entities, but subject to rules and policies that have more flexibility. The U.S. system, says Hunter, is focused on “expenditure control” rather than operational control, and auditors have more latitude to consider context “as opposed to norms that are more divorced from specific circumstances.”

MacDonald notes that Canada’s outmoded regulatory environment is inflicting a steep cost on the domestic economy and Canadian civil society, a sector that includes 13 million volunteers, two million jobs, and accounts for 8% of GDP.

Hayhoe adds another unintended layer: international charities, he says, chose not to locate their headquarters in Canada because our rules prevent them from effectively quarterbacking their cash resources and moving funds from country to country, as necessary. “All that is difficult to do in Canada,” he says. “This is a uniquely Canadian mistake.”