

Recent Tax Developments

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The 1990 Report of the Auditor-General: A Comment

The 1990 *Report* of the Auditor General of Canada to the House of Commons devoted an entire chapter to the tax treatment of charities and nonprofit organizations. The chapter provides an interesting and comprehensive overview of the financial relationship of charities to Canadian society, complete with statistics. The first part of the chapter focuses on registered charities and the last part on other nonprofit organizations.

It provides fascinating reading, revealing and outlining a vast network of devoted volunteers who contribute to, and significantly support, our social infrastructure in Canada. There are about 63,000 registered charities which are estimated to have about \$11 billion in property. If the charities did not exist, in many cases the work they do would fall to municipal, provincial and federal governments or would not be done. According to the *Report*, the tax advantages of being a registered charity (exemption from taxation and the ability to issue tax-deductible or tax-creditable receipts for donations) represents an estimated annual cost of \$820,000 in foregone revenue.

The audit focused on the following areas: registration, filing of annual returns, departmental audits of registered charities and of the charitable contribution deduction or credit, and the quality of information provided to the public in the Public Information Return which all charitable organizations must file annually. It identified a number of legislative rules that require clarification.

According to the *Report*, more than 31 per cent of the 63,000 registered charities do not file their returns on time. Although the Department of National Revenue, Taxation, has been advised by its legal services division that it does not have the authority to waive the late-filing penalty imposed under subsection 162(7) of the *Income Tax Act*, it has never applied it even though doing so would have yielded as much as

\$49 million a year. However, the Department has revoked the registrations of some charities which had failed to file. During 1989/90, the charitable status of 633 charities was revoked for failure to file a return while 334 charities had their registrations reinstated. In addition to making recent administrative improvements, the Department has advised the Auditor General that penalties are one of the principal areas of study in its current review of the tax treatment of charities. The *Report* concludes that the Department of National Revenue, Taxation should ensure that administrative rules and procedures provide an incentive for registered charities to file the annual Registered Charity Information and Public Information Return on time.

For other contraventions of the *Act* (excluding fraud), the only sanction available is the Department's ability to revoke registration. Because charities are often operated by volunteers, non-compliance may sometimes be the result of an oversight. Thus, the Department uses discretion in applying this sanction, and attempts to resolve problems or accepts an undertaking to comply in future.

With respect to receipts, the *Report* concludes that the Department does not have an appropriate audit program to determine the validity of receipts. Each year more than 63,000 registered charities may provide receipts for tax deductions or credits and, as a result, more than 4.9 million individuals claim tax credits. The *Report* recommends that the Department of National Revenue, Taxation establish an appropriate audit program to determine the validity of charitable deductions and credits claimed by taxpayers.

According to the *Report*, the audit identified a number of legislative rules that require clarification, including the following:

- (i) The provisions of the law pertaining to allowable business activities of charities are unclear and charities are able to circumvent what appears to have been intended. The conclusion is that although the legislation was intended to limit the business activities of registered charities, it is unable to do so.

The Department of Finance advised that it is aware that the tax treatment of business activities carried on by charities may require some legislative clarification. Any action must be carefully considered in order not to discourage charities from pursuing the legitimate fund-raising activities that may be necessary to ensure their financial stability.

- (ii) Abuses were found in instances where corporations who made charitable contributions to controlled private foundations borrowed money back and paid interest but the interest in turn was loaned back to the corporation. The funds were not being put to any charitable use by either the corporation or the foundations, yet the corporation lowered its taxable income by the amounts of the charitable contributions and the interest paid to the foundations. The *Report* suggests that it was probably never intended that this type of transaction should be legal.

In response, the Department of Finance took the view that changes to the law in this area may not be required as each case turns on its facts. If the facts support a finding that no valid gift has been made in the particular circumstances, the problem is solved. With regard to the issue of loanbacks to donors by private foundations, it is the Department's understanding that, again, each case turns on its facts, which may support a finding that no valid gift has been made to the foundation under the particular circumstances so no changes to the law may be required.

- (iii) Registered Canadian charities are required to demonstrate that foreign activities in which they are involved are their own and that the Canadian charity has retained control of its funds used abroad by others through an agency arrangement. The provision of the *Act* which allows donations to be made to charities abroad where Her Majesty in right of Canada has made a gift in the year, leaves room for abuses. The example cited of an annual gift of one dollar made for a number of years by the Department of National Health and Welfare to a foreign organization at the request of a Canadian taxpayer, presumably so the taxpayer could make a tax-exempt gift to the foreign corporation. This appears to circumvent the main rule that requires charities to retain control over funds used abroad. The Department of Finance advised the Auditor General that this is not considered to be a problem.
- (iv) With respect to public disclosure, the *Report* indicates that timely information is not always available to the public from the Public Information Return. It recommends that to obtain the information needed to improve the level of voluntary compliance and to improve tax legislation and regulation, the Department of National Revenue, Taxation should extend its

practices to include a program to measure compliance by registered charities.

Non-Profit Organizations

According to the *Report*, in 1986 there were an estimated 60,000 incorporated non-profit organizations in Canada; the number today is not known. There is no legislative requirement for registration; each organization may determine whether it qualifies as a non-profit organization under the *Income Tax Act*. Unlike registered charities, non-profit organizations are subject to no requirement to file an annual return unless they are incorporated or are trusts. Consequently the Department of National Revenue, Taxation has no effective check on an organization's right to enjoy exemption from taxation.

The *Report* points out some abuses in the non-profit area and recommends that the Department of Finance and National Revenue, Taxation review the legislative and administrative framework relating to non-profit organizations. The Departments responded to the Auditor General's recommendation and advised that they are reviewing the legislative and administrative framework and tax provisions governing non-profit organizations and will consider legislative action if appropriate.