

New rules for charities' fundraising expenses and program spending - questions for directors to ask

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Introduction

One of the responsibilities of the board of directors of a not-for-profit organization is to oversee the organization's compliance with applicable laws and regulations. The majority of not-for-profit organizations in Canada are registered charities under the *Income Tax Act*. Status as a registered charity provides benefits to the organization, but also imposes additional obligations on the organization and its directors.

In order to retain their tax-exempt status and in order for donors to receive a tax benefit for their donations, registered charities must follow a variety of rules, which are administered by the Canada Revenue Agency (CRA). The CRA's most severe sanction against charities that do not comply with the rules is to deregister them. The CRA may also impose less severe sanctions such as monetary penalties and suspension of receipt issuing privileges. Directors of registered charities can help their organizations avoid the potentially harsh consequences of deregistration or other sanctions by reviewing with management the charity's compliance with the CRA's requirements.

Directors of registered charities should be aware of several new developments which may affect the way that their organizations conduct operations:

- The CRA has released new guidelines on registered charities' fundraising expenses to provide more detailed information on the current treatment of eligible fundraising activities.
- The federal government proposes to ease the rules that determine how much a registered charity must spend each year on its charitable activities. These changes will apply for charities' fiscal years ending after March 3, 2010.
- The federal government proposes to strengthen existing anti-avoidance measures and introduce new ones in order to ensure that charitable donations are used for their intended purpose. The provisions will also apply to taxation years ending after March 3, 2010.

This Director Alert summarizes these developments and presents a series of questions as a catalyst for dialogue at the board level. Many of the questions are intended for directors to ask management, while others are questions for directors to discuss among themselves.

A. Guidelines for Fundraising Activities

The rules for registered charities generally require that a charitable organization devote all its resources to charitable activities, including gifts to qualified donees.

Although the CRA recognizes the necessity of fundraising for many charities, the CRA's recently revised guidance reiterates its policy that the act of fundraising is not viewed as a charitable activity. As a result, an organization that devotes too much of its energies to fundraising as opposed to fulfilling its charitable purpose may risk losing its status as a registered charity under the *Income Tax Act*.

As a general rule, CRA views fundraising as any activity that:

- includes a solicitation of support for cash or in-kind donations (including sales of goods and services);
- is part of the research and planning for future solicitations of support; or
- is related to a solicitation of support (for example donor recognition and donor stewardship).

Revised guidelines

The CRA's guidance, titled "Fundraising by Registered Charities" (CPS-028), provides more detailed information on the current treatment of fundraising under the Income Tax Act and under common law.¹ It is meant to provide readers a clearer understanding of CRA's policies relating to fundraising.

Prohibited activities

The guidelines state that fundraising activities are prohibited if they:

- are the main activity of the charity,
- result in more than an incidental personal benefit to individuals and corporations,
- are misleading or deceptive, or
- are illegal or contrary to public policy.

Reporting fundraising expenditures

Registered charities must report their fundraising expenditures to the CRA on the T3010B Annual Information Return. Fundraising expenditures include all costs related to any activity that includes solicitation of support. Exceptions to this rule for fundraising expenditures include expenditures relating to requests for government funding and expenditures for an activity "substantially all" of which advances an objective other than fundraising.

To meet the "substantially all" test, the charity must determine that 90% or more of the expenditures of an activity would have been undertaken even without a solicitation of support. If this test is satisfied, the charity does not report the expenditures as fundraising expenditures. CRA generally does not consider raising awareness of a charity's work when carried on in conjunction with a solicitation through a non-charitable third party (i.e. telemarketer) to qualify for the exception.

If an expenditure does not meet this "substantially all" test, the registered charity may allocate a portion of the costs as non-fundraising expenditures if it answers "No" to all of the following four questions:

- Was the main objective of the activity fundraising?
- Did the activity include ongoing and repeated requests, emotive requests, gift incentives, donor premiums, or other fundraising merchandise?
- Was the audience selected because of their ability to give?
- Was commission-based remuneration derived from the number or amount of donations?

¹ The guidance does not address whether the activity of a charity amounts to carrying on a business, and directors of registered charities should refer to the specific CRA guidance on this topic.

A. Guidelines for Fundraising Activities (continued)

With the disclosure of fundraising expenditures, the CRA can evaluate the quantum of the charity's fundraising activity by considering the ratio of fundraising costs to fundraising revenue. Fundraising revenue includes all amounts for which a charitable tax receipt is issued as well as all other revenue generated as a direct result of fundraising expenses.

The CRA has provided the following guidance on its views regarding this ratio:

- Under 35 percent — unlikely to generate questions and concerns by CRA on an audit.
- 35 percent and above — the CRA will examine the average ratio over recent years and determine the trend. The higher the ratio, the higher the likelihood that questions will be raised on an audit.
- Over 70 percent — unlikely to be acceptable unless the charity can provide a reasonable explanation.

Many charities are noticing increased interest on the part of donors, stakeholders and the media in the amount spent on fundraising, and directors should be mindful that information disclosed on the T3010B is publicly available. Directors should consider the potential impact of an organization's fundraising disclosures on its reputation and its ability to attract donations.

The CRA guidelines for fundraising activities should not be confused with accounting or financial statement reporting requirements. While compliance with the guidelines should not *require* a registered charity to alter its accounting policies or the manner in which it prepares its financial statements, it may influence how a registered charity discloses amounts relating to fundraising activities in its financial statements.

Questions for directors to ask:

1. Does the organization have policies in place to track expenditures for fundraising activities?
2. Does the organization have policies in place to identify and appropriately allocate portions of its expenditures as non-fundraising activities?
3. Has management reviewed the organization's fundraising plan in light of the CRA guidance? Have initiatives with high cost/revenue ratios received particular attention?
4. How do the organization's fundraising expenses compare with the ratios established by the CRA? If fundraising expenses are above the acceptable guideline, does the organization have an explanation?
5. How do the organization's fundraising expenses compare with those of similar organizations?
6. How might the organization's fundraising disclosures affect its reputation with members, donors and stakeholders?

B. Disbursement Quota Changes

The second development which directors of registered charities should be aware of is the federal government's recent proposal in the 2010 budget to ease the rules that determine how much a charity must spend each year on its charitable activities. These changes will apply for charities' fiscal years ending after March 3, 2010. While the 2010 budget has not yet been enacted, directors should consider the 2010 budget proposals as currently in effect for fiscal years ending after March 3, 2010.

Some of these changes were made in response to criticism from various charity groups that the previous rules were too complex and difficult for organizations that often depend on volunteers, and that the rules created a hardship for some smaller charities. The change is intended to decrease the administrative burden on charities and will likely affect the manner in which some organizations carry out their activities.

Background on the disbursement quota

Registered charities are required to spend a certain amount of their resources each year. This disbursement quota is designed to ensure that a reasonable proportion of the charity's resources are devoted to charitable purposes on a current basis.²

Under the existing legislation (i.e., before the budget announcement), the disbursement quota generally required that the amount a registered charity spent each year on charitable activities (including gifts to qualified donees) be at least the sum of:

- 80 percent of the previous year's tax-receipted donations, plus other amounts relating to enduring property and transfers between charities (the charitable expenditure rule) and
- 3.5 percent of all assets not currently used in charitable programs or administration, if these assets exceed \$25,000 (the capital accumulation rule).

Changes to the disbursement quota

The 2010 federal budget proposes to ease the disbursement quota requirements by eliminating the charitable expenditure rule that requires charities to expend 80 percent of their previous-year's receipted donations and certain other amounts. Thus, the disbursement quota will be based only on the capital accumulation rule's 3.5 percent of property owned by the charity that is not used directly in charitable activities or administration. However, the removal of the 80 percent disbursement quota does not mean that a charity can now encroach on existing endowment property without implications.

The government also proposes to increase the disbursement quota exemption threshold for accumulated capital to \$100,000 (from \$25,000) for charitable organizations (but not for charitable foundations, which will retain the \$25,000 exemption).

Changes to the accumulation of property rules

The federal budget proposes to amend the existing rule that provides the CRA with the discretion to allow registered charities to accumulate property for a particular purpose. Under the current rule, property accumulated after the CRA's approval and any income earned from that property is treated as having been spent on charitable activities as required by the charitable expenditure rule. Since the government intends to eliminate the charitable expenditure rule, approved accumulated property and income earned will simply be excluded from the charity's disbursement quota.

These changes will apply to registered charities' taxation years that end after March 3, 2010 and may have implications both for the way the organization chooses to conduct its operations, as well as the questions directors will need to ask to satisfy themselves of the charity's compliance with the CRA's requirements. However, it is important to note that the changes are not meant to permit transactions that were previously restricted. For example, registered charities cannot:

- distribute funds to foreign charities without proper oversight by the Canadian charity, or
- accumulate funds without a stated purpose or goal.

² Disbursement quota is a defined term found under section 149.1 of the Income Tax Act of Canada

Questions for directors to ask:

1. Has management reviewed the organization's funding plan in light of the changes to the disbursement quota? How might the organization take advantage of increased flexibility provided by the changes?
2. Are policies and procedures being maintained to segregate donations of endowment property made when the 80% disbursement quota was in place?
3. Is the organization compliant with the capital accumulation rule that requires a disbursement on charitable activities of 3.5 percent of all assets not currently used in charitable programs or administration?
4. Is the charity accumulating funds? Is there a plan consistent with the charity's objects to use these funds? Has the charity requested permission from the CRA to accumulate funds?

C. Anti-Avoidance Provisions

In order to ensure that charitable donations are used for their intended purposes, existing anti-avoidance measures were strengthened and new measures were proposed in the federal budget to discourage registered charities from entering into a transaction (including a gift to another charity) where a purpose of the transaction is to avoid or unduly delay the spending of funds on charitable activities.

The scope of the existing anti-avoidance measures, including penalties and possible revocation of charitable status, has been broadened to include not only gifts but all transactions in which any purpose (not just the main purpose) is to avoid or delay the expenditure on charitable activities.

The status of a registered charity may be revoked if it received a gift from another registered charity and has not either expended the funds in carrying out its charitable activities (in addition to its disbursement quota) or donated the funds to qualified arm's length donees. It may also be subject to a 110% penalty of the amount by which the gift received exceeds any amounts spent on charitable activities or disbursed to arms length qualified donees.

However, if the transferring charity elects that the amount transferred will not count towards satisfying its disbursement quota, the recipient charity would not be subject to the expenditure requirement under the anti-avoidance rules.

These provisions will apply to taxation years ending after March 3, 2010.

Questions for directors to ask:

1. Are the organization's policies regarding gifts to and transactions with other organizations in compliance with the new anti-avoidance provisions?
2. Are the organization's policies regarding funds received from other registered charities in compliance with the new anti-avoidance provisions?

D. Conclusion and Where to Find More Information

Directors of registered charities have an important obligation to ensure that their organizations comply with the law and the CRA's policies governing the use of funds, both for their fundraising efforts and for running their charitable activities, in order to safeguard the reputation of their organization and retain their charitable status.

CRA Guidance – Fundraising by Registered Charities

<http://www.cra-arc.gc.ca/tx/chrts/plcy/cps/cps-028-eng.html>

CRA Q&A – Disbursement Quota Reform

<http://www.cra-arc.gc.ca/gncy/bdgt/2010/chrt-eng.html>

Loris Giusto is an Associate Tax Partner in charge of KPMG's Not-for-Profit Tax Practice in the Greater Toronto Area. His not for profit practice ranges from assisting NPO's in registering with the Canadian tax authorities to advising on all manner of issues that arise in the income tax area as they relate to entities operating in this sector, including advice on completing documents required for tax compliance and interpreting communications issued by CRA relating to the sector.