

Budget 2004 - Charities Ever So Quietly Take Centre Stage

Barely noted in the stories that followed, the March 23, 2004 federal budget is the most significant and comprehensive budget statement on charities in decades. The budget treatment follows closely on the train of events set in motion by the Broadbent Report, followed on by the Working Together initiative and latterly the Joint Regulatory Table (JRT).

The modern administrative framework for charities under the *Income Tax Act* was initiated in 1976 and then given some significant revision in the 1983 budget – nearly twenty-one years ago. The 2004 budget starts with the 75 recommendations of *Strengthening Canada's Charitable Sector: Regulatory Reform*, the March 2003 report of the Joint Regulatory Table. The amazing fact is that the budget deals directly with about 72 of the JRT's 75 recommendations – and wholly adopts about 67 or 68 of them.

The stated purpose of these budget measures is twofold:

- To significantly improve the regulatory framework for registered charities; and
- by doing so, to enhance Canadians' confidence that charities are well managed.

The budget responds to the JRT recommendations concerning registered charities by proposing:

- a new compliance regime;
- a more accessible appeals regime; and
- more transparency and greater accessibility to information.

In addition, and unexpectedly, the budget proposes to partially revise the disbursement quota rules. While the devil is in the details – and the draft wording to give effect to the Notice of Ways and Means Motion tabled with the budget will come some months from now, there are several important issues that existing charities and organizations about to apply for charitable status need to know about and watch closely as more details become known.

Compliance Regime

On this topic the budget adopts several regulatory elements as advancing two key principles of regulatory reform, established by the JRT: to uphold the integrity of the provisions of the *Income Tax Act* and to facilitate public trust in the work of charities. There are three elements to be given priority in the administrative direction of the Charities Directorate of the Canada Revenue Agency and in changes to the *Income Tax Act*:

- Compliance through education: there will be an enhanced effort to make administrative rules clear and both better known and understood by charities.
- Compliance agreements: the Minister of National Revenue will use compliance

agreements to more closely monitor charities whose actions are questionable, with a view to establishing a balance of risk control, problem solving and compliance management; and

- Intermediate Sanctions: A broad and detailed set of taxes and penalties will fill the void created by, until this point, having no remedies available for sanction other than removing a charity's registration. Appeals from these intermediate sanctions will be to the Tax Court, ostensibly affording charities an accessible and inexpensive venue for determination when they have objections.

An important point to note is that no new rules are being introduced. There are no new offences. Charities have to comply with exactly the same rules that have existed up to now. The difference is that there may be penalties imposed that fall short of revocation. Notwithstanding these changes, it is possible that some charities may face financial penalties for violations that otherwise might not have been the subject of education letters or remediation agreements. Charities should review the list of proposed sanctions and obtain professional advice to ensure they do not expose themselves to sanctions.

Appeals Regime

One of the on-going debates in this area has been that appeals from decisions of the Canada Revenue Agency have had to go directly to the Federal Court of Appeal – an expensive and uncertain process, fraught with numerous technical difficulties. The budget proposed an altered appeal process, as noted above, by allowing appeals of taxes and intermediate penalties to the Tax Court. But now – importantly – registered charities and applicants will have access to the internal objection review process of Canada Revenue Agency regarding:

- Applications for registration that have been denied.
- Revocations or annulments of a charity's registration.
- De-registrations relating to whether a registered charity is a private or public foundation or one that is directly involved with charitable programs and services.
- Impositions of any taxes or penalties against a registered charity.

In summary, the first level of appeal will be the new CRA Internal Appeal Process. And that system must be used before going to the Tax Court to contest the imposition of the new taxes or penalties. But for those seeking a judicial determination about revocations or annulments of a charity's registration and de-registrations, the recourse will continue to be the Federal Court of Appeal, a significant failure in crafting a responsive and modern regulatory regime for charities under the *Income Tax Act*. Importantly, as part of this new regime, the objection process to the CRA Internal Appeal Process will be mandatory before an appeal may be made to a court.

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Transparency and Accessibility of Information

Under this heading, steps will be implemented to make more information about registered charities available, including financial statements and letters sent by CRA to a charity relating to the grounds for annulment of the charity's registration. In addition, information will be available about organizations denied registration, including a copy of any decision of the CRA's appeal branch about a notice of objection, if any, filed by an organization. There will be additional requirements for information on official tax receipts and as part of the move to greater accessibility, the Budget 2004 indicates that the Charities Directorate of CRA will move to increase public education on what donors need to be aware of when giving to charities, how to confirm the status of a charity, and how to file a complaint about a charity.

Finally, in an effort to establish a more transparent relationship with the charitable sector, there will be a newly created Charities Advisory Committee, composed of sector representatives and mandated to advise the Minister of National Revenue on a variety of administrative issues including those raised in the budget.

Disbursement Quota

The most surprising, and in some ways perhaps the most significant, announcement in the 2004 budget is the move to modify and broaden the disbursement quota (DQ) that until now only applied to public and private foundations. This is the requirement that charitable foundations annually spend 4.5% of the average fair market value of capital property (for example, investments) that are not used directly in charitable activities or administration, where the average is based on the immediately preceding 24 months. Charitable organizations will be familiar with the key feature of their own DQ - the need to spend on charitable activities 80% of tax received donations other than endowments received in the previous year.

The essential changes are threefold. First, the percentage has been lowered to 3.5%. Secondly, and here is the real change, that same 3.5% DQ will apply now to all type of registered charities — including charitable organizations. The budget commits to reviewing this rate periodically to ensure that it continues to be representative of long-term rates of return.

In order to provide charitable organizations registered before March 23, 2004 with sufficient time to adjust to this new requirement, this measure will apply only to their taxation years that begin after 2008. For charitable organizations registered after March 22, 2004, this measure will apply to taxation years that begin after that date.

The third essential change is a more technical one relating to capital gains – the tax term for the difference in value between the purchase price of an asset like a bond and the amount for which it is finally sold. Many charities hold capital endowments – shares, mutual funds and GICs – that produce investment income in the form of capital gains, dividends, and interest. Since an annual disbursement quota is applied on the value of these capital endowments, registered charities may need to use their investment income to meet their new disbursement obligations. In some cases, the return on an investment is weighted heavily in favour of capital gains, rather than cash flow such as dividends or interest. In these circumstances, a registered charity might prefer to meet its disbursement quota by realizing, and spending, capital gains that have accrued on their invested endowments. However, if the charity does so, under the rules before Budget 2004 it would have to then meet an 80% disbursement obligation to the extent that the proceeds of disposition are expended by the charity. This discourages registered charities from realizing capital gains in order to meet disbursement obligations to fund charitable programs and services.

Budget 2004 therefore proposes to reduce the 80% disbursement requirement that applies to the expenditure of proceeds from the disposition of these kind of endowments, by the lesser of 80% of the capital gain realized on the disposition and 3.5% of the value of all property not used directly in charitable activities or administration. This proposal will apply to taxation years that begin after March 22, 2004.

Budget 2004 doesn't stop there in its treatment of charities. It also deals with a number of other issues relating to transfers between registered charities, transfers of endowments, gifts by way of direct designation and endowments received and spent in the same year. Finally, the Budget proposes to amend the regulation to the *Income Tax Act* dealing with official receipts to require that, effective 2005, official donation receipts will have to tell donors that charities are monitored by the Canada Revenue Agency and list the website of the Charities Directorate. The exact wording will be provided later, when draft legislation is tabled.

As noted, while the exact details of the statutory changes will have to wait for the amendments introduced later this year to implement these proposals by changes to the *Income Tax Act*, this budget announces the most significant revision to the administrative rules for registered Canadian charities in more than two decades. It will require close scrutiny by the boards of charities, their senior managers, active volunteers, and the lawyers and accountants who assist them

with the ways to ensure compliance in the years ahead.

A useful place to begin is to review *Annex 9 Tax Measures: Supplementary Information and Notices of Ways and Means Motions*. The full document of the Budget Plan 2004 is available for downloading from the Department of Finance web site at www.fin.gc.ca/budget04/bp/bptoce.htm.

Those working with and for charities need to understand the significant changes that are proposed by Budget 2004 to their regulatory relationship with the Charities Directorate of the Canada Revenue Agency. These changes auger both for a more technical future and, for good or ill, more attention from government.

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