

# Breaking Down the Borders — Operating Charitable or Tax Exempt Organizations Across the Canada/US Border

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Tax exempt organizations in the United States and registered charities in Canada are increasingly interested in fundraising and carrying on their charitable activities across the 44th parallel. Organizations seeking to do this need to ensure they understand the various rules that apply in each country. These rules impact whether an organization situated in Canada, for example, is able to fundraise from individuals or other charities in the United States and they impact on how, once the fundraising is done, those dollars can be spent.

This article will provide a general overview of the legal requirements affecting Canadian registered charities that raise funds and/or attempt to conduct or fund activities in the United States. It will do so in part by contrasting the Canadian rules with their less stringent US counterparts.<sup>2</sup>

## United States – Canada Income Tax Convention (the “Tax Convention”)

It is useful to start this discussion with a brief summary of the rules contained in the Tax Convention’s Article XXI – Exempt Organizations. Article XXI confirms which types of organizations qualify for tax exemption in the other country and to what extent donations by residents of one country to organizations in the other are tax recognized in the donor’s home country. No other Canadian tax treaty contains provisions like Article XXI — a recognition of the close ties between Canada and the United States.

The organizational tax exemption is found in paragraph one of Article XXI and as drafted indicates that organizations that are

religious, scientific, literary, educational or charitable are exempt under the Treaty. Generally, Canada recognizes organizations that are 501(c) (3)’s as exempt under this paragraph and similarly the United States recognizes Canadian registered charities as generally exempt. Note that the tax exemptions in the Tax Convention do not apply to the business income of a charity earned in the other jurisdiction.

Article XXI of the Tax Convention also assists in the area of fundraising. Generally, donations to a US charity by a Canadian donor would not result in a tax credit under Canada’s *Income Tax Act* (the “*Tax Act*”) when filing the Canadian donor’s tax return. Similarly US donors contributing to a Canadian charity cannot use the Canadian tax receipt when calculating taxes payable.

Article XXI provides some relief. Under the Tax Convention, a US taxpayer is permitted to claim a deduction for a donation made to a Canadian charity against any Canadian source income the taxpayer has earned. This would reduce US taxes payable on the Canadian source income. Similarly, a Canadian taxpayer wishing to make a donation to a US tax exempt organization is able to claim a credit for the donation to be used in calculating Canadian taxes payable if that Canadian taxpayer has income from a US source. In each case, the benefit that applies mirrors the benefit available to domestic gifts.

## US Charities Fundraising from the Public in Canada

We have discussed the Tax Convention rules permitting limited tax recognition for gifts by the resident of one of Canada or the US to the other. These treaty provisions are necessary

because neither country's domestic tax law recognizes charitable gifts other than to a domestic organization. In the case of Canada, only a gift to a qualified donee gives rise to a personal donation tax credit or a corporate tax deduction. Thus, a US tax exempt organization seeking to fundraise from Canada needs to become a qualified donee. However, the only general category of qualified donee, that of registered charity, requires that the applicant entity be both resident in Canada and created or established in Canada — neither qualification could be met by a US charity. As a result, it is necessary for the US charity to establish a Canadian Friend charity to raise money in Canada. This Canadian Friend will be subject to all of the Canadian tax rules on foreign charitable expenditures described below. Indeed, the Canada Revenue Agency ("CRA") is concerned about conduits and will be suspicious of Canadian Friend entities in practice on application for registration. Nonetheless, it is possible to register a Canadian Friend of a US charity.

### Canadian Charities Fundraising from the Public in the US

Subject to the limited exception above for US taxpayers with Canadian-source income, US taxpayers giving to a Canadian charity do not receive any income tax recognition for their gifts. However, we understand that it is possible for a US Friend of a Canadian charity to be established, again subject to IRS concerns about a pure conduit.

### Canadian Charities Operating in the United States<sup>3</sup>

The *Tax Act* provides that a Canadian charity can only operate in two ways: by making gifts to "qualified donees," or by carrying out its own charitable activities at home or outside Canada. More particularly, the *Tax Act* defines a charitable organization in part as an organization "all the resources of which are devoted to charitable activities carried on by the organization itself [our emphasis]." In other words there is much focus on the Canadian registered charity "doing" the activity rather than granting its funds to a third party that might be pursuing similar charitable objects. These two categories of operations and their overlap will be discussed more fully below.

### Gifts to Qualified Donees

The limit on the type of entity to which a registered charity may make gifts or grants is quite restrictive because the definition of qualified donee is limited to include, among other entities, Canadian registered charities, the United Nations and its agencies, all levels of Canadian government and a small number of foreign entities including a foreign charity that has received funds from the Canadian federal government within the last or preceding year

and a foreign university customarily attended by Canadians. Noticeably absent from this list are foreign charities, generally. The consequence of this is that a Canadian registered charity cannot simply transfer money or other resources to a foreign charity. One might ask if such a transfer could be made as part of the Canadian organizations charitable operations. The answer, however, is that since the foreign charity is not a qualified donee such a transfer does not qualify as carrying on its own charitable activities.

One minor exception to this harsh rule is that it is possible to transfer some types of goods to a foreign charity if it is done in the course of the Canadian charity's own activities and if the nature of the property is such that it could only be used for a charitable purpose. The policy that permits this has in the past been referred to internally at the CRA as the "charitable goods policy." The CRA's "Canadian Registered Charities Carrying Out Activities Outside Canada" guidance (the "Guidance") includes an example of a Canadian charity registered transferring books and scientific reports to a reputable foreign library or school. Such a wholesale transfer of property is considered reasonable because it is a distribution of resources while carrying out a charitable activity and the charity can be reasonably sure that the items will only be used for educational (*i.e.* charitable) purposes.

### "Own" Charitable Activities

The fact that a Canadian registered charity is generally prohibited from granting to a foreign charity means that the focus for Canadian registered charities that wish to support charitable projects in the United States or elsewhere outside of Canada is on how to demonstrate that the activities are their "own" activities rather than simply grants to a US or other foreign charity. The easiest way is through the Canadian charities' own employees and volunteers but more often than not it will be necessary to pursue these activities either through or in conjunction with intermediaries.

CRA considers a charity's "own activities" to be those it carries out itself directly through employees and volunteers or those carried out through intermediaries. The charity must be able to demonstrate that it controls and directs its "own activities", the physical, financial and material resources devoted to such activities and the representatives or intermediaries working on them. The Canadian Federal Court of Appeal in *Canadian Committee for the Tel Aviv Foundation vs. the Queen* 2002 FCA 72 held that a Canadian charity must maintain direction and control over its resources when carrying out its activities through an intermediary, otherwise the activities will not be considered to have been carried out on the Canadian charity's behalf. The CRA has identified a number of means by which a Canadian charity can demonstrate that it has the requisite control and direction over its activities.

While the primary one is through the terms of an appropriate written agreement, there are other means of showing direction and control.

As CRA notes in the Guidance, there is no legal requirement to have a written agreement in place between a Canadian charity and a foreign intermediary that is conducting activities on behalf of the Canadian charity. A written agreement is, however, often the most effective way of establishing that a charity is in control of its activities and CRA, in practice, requires that a written agreement be in place. In the Guidance, CRA “recommends that a charity enter into a written agreement with any intermediary.” CRA also states that it is prepared to accept a less formal agreement where the money spent does not exceed C\$1,000 in any year. This suggests that CRA is not prepared to accept less than a written agreement in most other circumstances, and in the authors’ experience, this is indeed the case. Since liability for the Canadian charity could arise from the activities of an intermediary, it would be prudent to have a written agreement in place — if the details of the activities of the intermediaries are not recorded in writing, it will be impossible to argue that a particular activity is not within the scope of the intermediary’s authority. The Guidance also contains a list of the basic elements of written agreements between a Canadian charity and a foreign intermediary as a useful reference.

There are other means by which a Canadian charity can demonstrate direction and control over an activity. These include by providing documentary evidence to support the activity’s “exact nature, scope and complexity.” The Guidance also includes a list of reporting methods which could satisfy these requirements although they are dependent on the type, complexity, duration and expense of the activity.

The Guidance provides that a Canadian charity should undertake regular monitoring and supervision of an intermediary and of the activities undertaken on its behalf, and that records of any ongoing instructions given to the foreign intermediary will assist in demonstrating that the “direction and control requirement” is being met. It is also suggested that Canadian charities make periodic transfers of funds to its intermediaries based on demonstrated performance so that the Canadian charity can discontinue the transfer of funds if its directions and instructions are not being followed. For the Canadian charity’s protection, a provision specifying that the Canadian charity is under no obligation to provide funds and may withhold funds without cause, should be included in a written agreement with an intermediary. Otherwise, the Canadian registered charity could be required to show cause in a foreign and possibly corrupt court. Finally, CRA also requires, as stated in the Guidance, that a Canadian charity be able to distinguish its activities from those of

the foreign intermediary. For that reason, in certain types of arrangements such as where there is an agency agreement in place, CRA requires that separate bank accounts be maintained and funds be accounted for separately from those of the intermediary.

### Specific Intermediary Relationships

Out of this general framework of common law and statutory rules emerges several different ways in which a Canadian registered charity *can* legally operate overseas. A Canadian registered charity is, of course, able to carry on activities outside of Canada through its own staff and volunteers. However, if it does not wish to carry on its own activities this way, it can use intermediaries and still meet the legal requirement that its foreign activities be considered its “own activities”. Although CRA had previously provided examples of arrangements using intermediaries, the Guidance is helpful to Canadian charities in that it first defines and then provides more detailed examples than it has previously given, of the types of intermediaries available to carry out a Canadian charity’s activities.

#### A) Agents

A very common way for a Canadian charity to operate internationally is through the appointment of a common law agent to carry out charitable activities. In the Guidance, CRA defines an agent as “an intermediary that agrees to carry out specific activities on a charity’s behalf.”

Although there is no basis in the general law of agency for the requirement that a Canadian charity maintain direction and control over its agent’s activities, the Federal Court of Appeal did find this to be a necessary element to the agency relationship in the *Tel Aviv* case. That said, the CRA acknowledges in the Guidance that agency does permit a Canadian charity to delegate day to day decision making to the foreign agent. The Guidance says very little about the requirements of an agency relationship and it does caution registered charities to consider carefully how they structure agency arrangements “since the existence of the agency relationship may expose them to significant liability for the acts of their agents.”

#### B) Joint Venture Participants

Another way for a Canadian charity to carry out activities abroad is through the use of a joint venture arrangement. Here a Canadian charity partners with another organization by pooling resources to carry out a particular project. The CRA, in looking at such a venture to ensure that a charity is furthering its own charitable purposes and conducting its own activities, will expect to see that the Canadian charity must be able to establish that its “share of authority and responsibility over the venture allow the

charity to dictate, and account for, how the resources are used. If the charity does not have enough decision-making authority to make sure that its resources are used as it directs, it may have difficulty establishing that it is carrying on its own activities.” In order to demonstrate this share of authority and responsibility, it is typical for a charity to have some of its members sit on the governing board of the joint venture for the duration of the project. This latter element is listed in Appendix E to the Guidance as one of the factors that the CRA will look for in a joint venture agreement.

Our experience is that Canadian charities sometimes set up joint venture agreements and then ignore the governance mechanisms described in them. If a joint venture agreement is entered into, the charity should be advised to make sure that it can carry out the arrangement as set out in the agreement, and then ensure that it does so, otherwise the arrangement could be viewed as a sham.

### C) Cooperative Participants

A Canadian charity may also conduct its activities jointly with a “cooperative participant”. In the Guidance, CRA defines a cooperative participant as “an organization that a charity works side by side with to complete a charitable activity.” CRA distinguishes this arrangement from a joint venture arrangement on the basis that the charity and other organization(s) each take on a responsibility only for specific parts of the project. The Guidance includes an example of a Canadian charity partnering with a foreign organization that is building and operating a medical clinic in a remote area, to provide nurses for the clinic. The Canadian charity is only involved in the provision of the nursing staff to the clinic and not the construction of the clinic or the purchasing of medicines, etc.

### D) Contractors

The final category of intermediary listed in the Guidance is that of a contractor. A contractor is defined as “an organization or individual that a charity hires to provide goods and/or services.” By way of example, the CRA suggests a charity might “hire a for-profit company to dig a well in a foreign country for people lacking clean drinking water.”

The Guidance further confirms that the “direction and control” required is “Usually exercised through the terms of the contract between the charity and the person or business providing the goods or services.” Our experience is that the degree of direction and control expected by the CRA is perhaps greater in the context of this approach than in the context of an agency relationship.

## **US Tax Exempt Organizations Operating in Canada**

The US approach to foreign activities and grantmaking by tax exempt organizations is very different. IRC Section 501(c) (3) provides that an organization may qualify for tax exempt status only if it is organized and operated exclusively for exempt purposes. There is nothing in the US law that requires the charity to engage in the activity directly as there is in Canada. There is also nothing under US law or regulation that limits what type of entity can receive grants from a US charity. The main requirement is that the US charity be able to demonstrate that the grant making is done in furtherance of its exempt purposes. Whether that grant is received by a foreign or domestic organization does not matter. Nor does it matter whether it is received by a tax exempt organization or a for profit entity — what is key is that it can be established that it is used for the intended exempt purposes.

This does not mean that there are no restrictions on how the US charity can operate abroad. A US charity can be challenged on an audit to demonstrate that it has taken reasonable steps to ensure that its assets are being directed to the intended exempt purposes and that those purposes are consistent with the exempt purposes of the US entity. Such reasonable steps can include the US charity demonstrating it has sufficient control and involvement to ensure the funds are used for the intended exempt purposes. Is this the same as the requirement for direction and control that was discussed above for Canada? Likely not, but it is clear that the US charity could be required on audit to demonstrate that a reasonable effort was taken to ensure that the grants made are used by the grantee to fulfill the intended exempt purposes.

US private foundation grant makers granting to Canadian charities are subject to somewhat more stringent rules. These require US private foundations to follow specific procedures when making the grant known as expenditure responsibility or make an equivalency determination that the Canadian grant recipient is equivalent to a US public charity. These expenditure responsibility rules require the similar effort, due diligence and ongoing oversight as would be required of a Canadian charity operating through a US intermediary organization on a charitable project. In other words these rules require written agreements to be entered into with grantees and regular reporting concerning how the funds are spent.

It is possible for a Canadian charity to apply for its own 501(c)(3) determination in the US which would result in the Canadian charity being considered by the IRS as a public charity (Canadian charities are otherwise considered private foundations and subject to the more restrictive rules). If the Canadian charity receives this determination and is considered as a public charity, US private foundations can grant to it without being concerned about the expenditure responsibility requirements.

Notwithstanding the availability of this special designation, the authors understand from their peers in the United States and from Canadian charities that it is rarely used — it would really only be beneficial if the Canadian charity knew significant grants would be available. The reason for this is that once designated, the Canadian charity is required to file the Form 990 Annual Return in the United States in respect of all its operations. The benefit would have to be significant to justify having to meet that filing requirement if the Canadian charity has limited operations in the United States.

### Conclusion

This overview leads us to a number of conclusions. First, the Tax Convention does contain some provisions that assist in the cross border activity of charities and donors. The benefits of the Tax Convention are however quite limited so careful consideration must be given to the rules and regulations of each country.

Second, for a US tax exempt organization interested in accessing donor dollars from a Canadian entity or from Canadian public donors, the rules are more restrictive. A Canadian

registered charity is not permitted to make grants to a non-qualified donee. It would therefore not be possible for a US charity to establish a Canadian resident charity with a view to accepting donations from Canadian taxpayers which could then be granted to the US charity for use in its charitable activities. Rather, in order for the US charity to raise funds in Canada, it in fact must establish another organization in Canada, have that new organization registered with the CRA and then, the new organization would either carry out its activities directly or make grants to other qualified donees.

Third, a Canadian charity when considering using its own assets abroad is subject to those same restrictions, but when considering how and if it can access donor dollars from US organizations or individuals it has greater flexibility because a US grant maker has more flexibility to grant to Canadian charities.

It becomes clear when considering the rules that apply to charities operating in Canada and the United States that careful consideration is required of the rules and regulations when embarking on activities and fundraising abroad to ensure the rules are understood and followed. ■

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2. Of course, the authors are Canadian qualified lawyers only. Any discussion of US tax rules and regulations applicable to either US tax exempt organizations operating abroad or to Canadian registered charities operating in the US is provided for comparison purposes only and is based on secondary sources. For more description of the US rules and additional comparison of them with the Canadian rules see P. Boyle, R.B. Hayhoe, L. Mellon and L. Woods, "Canada-US Boundary Issues for Cross-Border Charitable Activities" [November-December 2006], *The Taxation of Exempts* 129.
3. The CRA's policy on Canadian charities operating outside of Canada has been consolidated in a new policy guidance: "Canadian Registered Charities Carrying Out Activities Outside Canada" (July 8, 2010), available at <http://www.cra-arc.gc.ca/chrts-gvng/chrts/plcy/cgd/tsd-cnd-eng.html>





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