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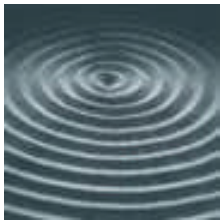

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Operating outside of Canada: what's new, what's right and what's wrong

Robert B. Hayhoe

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OPERATING OUTSIDE OF CANADA: 'WHAT'S NEW, WHAT'S RIGHT AND WHAT'S WRONG'

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I. Introduction

The tax law rules which apply to Canadian registered charities wishing to carry on foreign activities or fund activities of foreign charities do not facilitate international philanthropy by Canadians. These rules permit a Canadian registered charity to carry on activities anywhere in the world, so long as the Canadian charity carries on its own activities and does not merely fund the charitable activities of another. However, it is accepted as being possible for a Canadian registered charity to carry on its own activities through a foreign agent or through a foreign joint venture arrangement. There is no apparent policy rationale for this distinction.[1] Nevertheless, the goal of this paper is not to provide a policy critique of the current rules for Canadian charities operating abroad,[2] but the more modest one of describing the current legal rules applicable to the foreign operations of Canadian charities. This paper is also designed to incorporate some detail the newly clarified administrative position of the Canada Revenue Agency Charities Directorate on Canadian charities carrying on foreign activities.[3]

II. Statutory Background

There are two kinds of registered charities contemplated by the *Income Tax* Act[4], charitable organizations and charitable foundations. Although the limits on what foreign activities and grant making each can do are now functionally the same, the statutory regime by which the applicable limitations are imposed is slightly different. I will therefore address each in turn.

(a) Charitable Organization

A charitable organization is defined as "an organisation… all the resources of which are devoted to charitable activities carried on by the organisation itself".[5] Thus, a charitable organization is *prima facie* limited to applying all of its resources to its own charitable activities. However, the *Income Tax Act* deems a charitable organization which devotes up to 50% of its income to making grants to other qualified donees (as described further below) to be devoting its resources

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1 This has been observed by a number of writers: E. Blake Bromley, "Political, Foreign and Business Activities: Problems in the Law of charities," in *Report of the Proceedings of the Forty-First Tax Conference*, 1989 Conference Report (Toronto: Canadian Tax Foundation, 1990) 36:1 at 36:25-26; Robert B. Hayhoe, "A Critical Description of the Canadian Tax Treatment of Cross-Border Charitable Giving and Activities" (2001), 49 *Canadian Tax Journal* 320 (hereinafter "Hayhoe Critical"). Ronald Knechtel suggests that the requirement that at registered charity carry on its own activities is consistent with trust law in that a trustee may not delegate the management of charitable property and making grants to foreign charities would be an impermissible delegation: Ronald C. Knechtel, "Compliance Issues in Operating Charities," in *Report of the Proceedings of the Forty-Ninth Tax Conference*, 1997 Conference Report (Toronto: Canadian Tax Foundation, 1998), 28:1 at 28:20. With respect, Mr. Knechtel has missed the distinction between a charity delegating the management of charitable property (perhaps not permitted by trust law) and a charity making a gift to another charity (permitted by trust law).

2 I have previously written such a critique: Hayhoe Critical, supra note 1.

3 Now that the Canada Revenue Agency Charities Directorate releases technical interpretation letters and internal policy documents on its website at <www.ccra-adrc.gc.ca/tax/charities/policy>, the ability of charity tax lawyers to understand the thinking of the Canada Revenue Agency on issues is much improved.

4 S.C. 1985, c.1 (5th Supp.) as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this paper are to the Act.

5 Subsection 149.1(1).

to its own charitable activities[6]. Thus, a charitable organization may either carry on its own charitable activities or make (limited) grants to qualified donees.

(b) Charitable Foundations

By contrast[7], a charitable foundation is defined as a corporation or trust with exclusively charitable purposes which is not a charitable organization.[8] Reading the definition of charitable organization and charitable foundation together leads to the conclusion that a charitable foundation is a charity which can devote as much of its resources as it desire to making grants to other charitable entities.[9] Thus, there is nothing in the definition of charitable foundation to prevent a charitable foundation from making grants to foreign entities which have exclusively charitable purposes. However, the disbursement quota imposes upon a charitable foundation[10] a requirement that it spend in any given year the sum of 80% of its previous year's receipted donations and 3.5% of its average investment asset value on either its own charitable activities or on grants to other qualified donees.[11]

At one point, the Canada Revenue Agency apparently issued letters (including registration letters for new charitable foundations)[12] which confirmed that a charitable foundation which had met its disbursement quota was entitled to make grants for charitable purposes including grants to foreign charities. However, at some point, the Canada Revenue Agency changed its mind and began to apply a policy of limiting charitable foundations to funding only qualified donees. At the time the change occurred by administrative fiat, there was absolutely no statutory foundation for it.[13]

In fact, when Wolfe Goodman's private foundation challenged the position of the Canada Revenue Agency by way of an application before the Ontario Courts seeking confirmation that a grant to a foreign charity met the charitable purposes of his private foundation, the Canada Revenue Agency reluctantly confirmed to him that his position was correct as a matter of law.

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6 Subsection 149.1(6).

7 For more detail on the difference between a charitable organization and a charitable foundation, see David P. Stevens, "Update on Charity Taxation," *Report of Proceedings if Fifty-Third Tax Conference*, 2001 Tax Conference (Toronto: Canadian Tax Foundation, 2002, 28:1 at 28:11).

8 Subsection 149.1(1)

9 It might be argued that because subsection 149.1(1) defines charitable purposes to include the making of grants to qualified donees, such grants would all otherwise not be charitable. This would be an inaccurate characterisation. The above deeming provision is necessary because certain qualified donees are not necessarily charitable at law (the United Nations is a good example). Grants to other charities would be permitted for a registered charitable foundation even without this rule.

10 The 2004 Budget imposes a similar requirement on charitable organizations (prior to the Budget, only 80% requirement applied to charitable organizations): Canada, Department of Finance, 2004 Budget Tax Measures: Supplementary Information at 361-362 <http://www.fin.gc.ca/budtoce/2004/budliste.htm>. For charitable organizations already registered on March 22, 2004, only the 80% expenditure requirement applies - the 3.5% requirement will not take effect until 2008.

11 Subsections 149.1(1), 149.1(3) and 149.1(4), as amended by 2004 Federal Budget Annex 9.

12 Arthur B.C. Drache, "A Pyrrhic Victory?" (2000) 8 *Canadian Not-for-Profit News* 77 (hereinafter "Drache Pyrrhic"); Canada Revenue Agency Charities Information Letter CIL – 1999-003.

13 As has been observed by various commentators: Drache Phyrric , supra note 12 at 78; Hayhoe Critical, supra note 1 at 331 and Stevens, supra note7 at 28:39.

However, Mr. Goodman's victory was short-lived in that the Department of Justice confirmed to him at that point that the Department of Finance would be amending the *Income Tax Act* to prevent charitable foundations from making foreign grants after they had met their disbursement quota.[14]

In late 2002, the *Income Tax Act* provisions providing for revocation of registration for each of charitable organizations, private foundations and public foundations were amended to cause the making of a gift other than to a qualified donee or in the course of charitable activities, to be an explicit ground for revocation of registration.[15] The 2004 Budget also provides that the making of a grant by a registered charity to an entity which is not a qualified donee is grounds for the imposition of intermediate sanctions.[16] Specifically, a charity which makes a gift that is restricted as set out above can be subject to a tax of 105% of the restricted gift on a first offence and 110% for subsequent gifts. However, if the intermediate sanction tax exceeds $1,000 in a year, the penalized charity may apply to the Canada Revenue Agency for permission to meet its intermediate sanction through an equivalent payment to an arm's length charity.

Thus, it is now the case that neither a charitable organization nor a charitable foundation may make grants other than to a qualified donee or in furtherance of direct charitable activities carried out by the Canadian registered charity. There is no *de minimus* exception permitting small grants to foreign charities.[17]

III. Qualified Donees

The *Income Tax Act* provides for a number of different types of qualified donees.[18] The relevant qualified donees in a cross border or foreign activity situation include other Canadian registered charities, the Crown in Right of Canada or a province, the United Nations and its agencies, a foreign university customarily attended by Canadians, and a foreign charity which has received a gift from the federal Crown in the year or the preceding year.

(a) Canadian Registered Charity

"Registered charity" is defined[19] to require organizational purposes which are exclusively charitable, the creation and establishment of the organization in Canada, and application to the Canada Revenue Agency in prescribed form. As a result of the requirement that a registered charity be resident and created or established in Canada, it is not possible for a non-Canadian

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[14] See Drache Pyrrhic, supra note 12 for more detail of the Wolfe Goodman challenge to the Canada Revenue Agency position.

[15] Paragraph 149.1(2)(c): charitable organizations; paragraph 149.1(3)(c): public foundations and paragraph 149.1(4)(c): private foundations.

[16] Supra note 10 at 353.

[17] Canada Revenue Agency Charities Information Letter CIL – 1999 - 011.

[18] As defined in subsection 149.1(1) and listed in subsections 110.1(1) and 118.1(1). For a more complete discussion of the list of qualified donees in the context of cross-border charitable activities, see Hayhoe Critical supra note 1 at 322-327.

[19] In subsection 248(1) and subsection 149.1(1).

charity to become a registered charity. For this reason, non-Canadian charities wishing to fundraise from Canada must establish a separate Canadian entity which then seeks registration.[20]

(b) United Nations and its Agencies

It is clear that a Canadian registered charity may make grants to the United Nations. What is less clear in some cases is what constitutes an agency of the United Nations. There may in some circumstances be a concern that the Canada Revenue Agency will take a highly technical approach and conclude that a particular United Nations related entity does not meet the requirements to be a common law agent of the United Nations.[21]

(c) Prescribed Foreign University Customarily Attended by Canadians

A foreign university that consistently has a significant number of Canadian students is eligible to become a qualified donee through the promulgation of a regulation of the *Income Tax Act*[22] confirming that it is customarily attended by Canadians. Such a regulation is important both to ensure that it is a qualified donee for the purpose of receiving grants from Canadian registered charities and gifts from Canadian resident individuals and corporations but also for the purpose of ensuring that the Canadian resident students of the university are eligible for individual tuition and education tax credits. The International Directorate of the Canada Revenue Agency administers the list of prescribed universities. In a number of technical interpretations, the Canada Revenue Agency has set out the procedure for a foreign university to follow in becoming a prescribed foreign university.[23] It is also important to realise that only the foreign university

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[20] For a detailed description of practical considerations for a foreign charity to keep in mind in such a situation see: Terrance S. Carter, "US Tax Exempt Organizations Commencing Charitable Operations in Canada and International Structuring" (1999), 11 *Journal of Taxation of Tax Exempt Organizations* 128 or Robert B. Hayhoe, *Fundraising From Canada* (United Kingdom, Chapel & York: 2001) at 36.

[21] Hayhoe Critical, supra note 1 at 325 discusses *Murdoch v. M.N.R.*, 79 D.T.C. 206 (T.R.B.) in which the Board took just such a technical position in the context of an agent of the Crown.

[22] *Income Tax Regulation*, Schedule VIII.

[23] To summarize from Canada Revenue Agency Charities Information Letter CIL – 1998 – 025 (September 9, 1998), a university seeking to become a prescribed foreign university should apply to the International Tax Directorate of the Canada Revenue Agency enclosing:

- a letter from the appropriate regulatory authority confirming that the institution grants degrees at least at the baccalaureate level;
- a copy of the institution's governing legislation;
- a recent course calendar or syllabus showing the curriculum; and
- enrolment records for the last ten years showing the number of Canadian students in each year, with names and addresses (recent experience is that social insurance numbers are also required).

My experience of such applications is that while the Canada Revenue Agency International Tax Directorate will typically confirm within about six months that a foreign university meets the requirements to be prescribed, there are often significant delays after such confirmation is issued. These additional delays result from the fact that the Canada Revenue Agency does not on its own have the power to make regulations and the practice has arisen that the regulation providing the list of prescribed universities is only updated once per year (and not at a consistent time).

itself is eligible to be prescribed – there is no qualified donee eligibility for foreign university foundations or other charities associated with foreign universities.[24]

(d) Foreign Charities with Recent Federal Crown Patronage

The Act provides that a foreign charity which has received a gift from the Federal Crown in the current or immediately previous taxation year is a qualified donee. The Canada Revenue Agency Charities Directorate maintains an updated list of foreign charities which it is willing to recognize officially as having received a recent gift from the Federal Crown.[25]

The Act states only that the foreign charity must have received a gift from the Federal Crown in the previous year. The Canada Revenue Agency's insistence that a foreign charity must be listed on the Canada Revenue Agency's official list of foreign charities which have received a gift from the Crown is a requirement without any statutory foundation. [26] A foreign charity which receives a transfer of property made without consideration or expectation of material benefit[27] has received a gift from the Federal Crown. The most notable example of foreign charities which, in my view, often receive gifts from the Federal Crown are foreign relief and development charities which receive Canadian grant money from the Canadian International Development Agency. Since the Canadian International Development Agency is an integral part of the Federal Crown[28], a grant from it is a grant from the Crown.

Despite an earlier more sensible position,[29] the Canada Revenue Agency now appears to suggest that the reporting conditions which are placed on a Canadian International Development Agency grant are sufficient to cause the grant to not be a gift. There is no apparent legal basis for this position. In fact, I have seen this issue raised in the course of a threatened revocation of registration of a Canadian registered charity (for funding organizations which had recently received Canadian International Development Agency grants). The audit file went strangely silent after the argument was raised. [30]

As a practical matter, it is sometimes possible to arrange for the federal Crown to make a small gift to a foreign charity for the specific purpose of causing the foreign charity to become a qualified donee.[31] In fact, the Canada Revenue Agency is on record as having suggested this

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[24] Canada Revenue Agency Charities Information Letter CIL – 1997 - 006

[25] Information Circular 84-3R5, *Gifts to Charitable Organizations Outside Canada* as updated by periodic attachments.

[26] Hayhoe Critical, supra note 1 at 326.

[27] *Woolner* v. A.G. Canada et al., 99 D.T.C. 5722; [2000] 1 C.T.C. 35 (F.C.A.).

[28] *Department of Foreign Affairs and International Trade Act*, R.S.C. 1990, c.E-22, paragraph 10(2)(f).

[29] Hayhoe Critical, supra note 1 at 326-327.

[30] Perhaps an example of the Canada Revenue Agency learning from its loss in *Longley v. M.N.R.*, 99 D.T.C. 5549 (S.C.B.C.), and declining to rely formally on positions which it likes from a policy perspective but has been advised do not have a legal basis.

[31] In 1990, the Auditor General identified this as a serious flaw in the Canadian tax system because it allowed donations to foreign charities over which the Department of National Revenue had no authority: Canada, *Report of the Auditor General of Canada to the House of Commons* (Ottawa: Supply & Services, 1990) at paragraph 10.100.

approach to a Canadian charity wishing to make a grant to a foreign charity.[32] The Canada Revenue Agency suggests arranging for a gift, then providing the following to Charities Directorate[33]:

- a copy of the governing document of the foreign entity;
- a copy of the foreign entity's domestic charitable registration;
- documentary evidence of the federal Crown's gift (a letter from the federal department which made the gift)

IV. Canada-US Treaty[34]

It may be possible to rely on article XXI(6) of the Canada-US treaty[35] to argue that gifts by a Canadian charity to a US charity are permitted and should count toward the disbursement quota of the Canadian charity. Article XXI(6) provides in part:

> For the purposes of Canadian taxation, gifts by a resident of Canada to an organization that is a resident of the United States, that is generally exempt from United States tax and that could qualify in Canada as a registered charity if it were a resident of Canada and created or established in Canada, shall be treated as gifts to a registered charity.

This language is the preamble to a paragraph providing for Canadian recognition of charitable donations by Canadians to US charities to the extent of Canadian tax paid on US source income. The question of statutory and treaty interpretation that arises is whether the above preamble can be applied independently to Canadian grant-making charities or whether it applies only to non-exempt taxpayers making cross-border donations.

If article XXI(6) applies to Canadian charities, it could be used to permit grants by Canadian charities to US charities. As discussed above, a registered charity that is a charitable organization can give up to 50% of its income to other registered charities and a registered charity that is a foundation can give all of its income to qualified donees (including registered charities). Since the Canada-US treaty deems gifts to a US charity that could be registered in Canada if it met the residency and establishment tests to be gifts to a registered charity[36], it could certainly be argued that a Canadian registered charity may make a grant to such a US charity and thereby meet its disbursement quota and the other requirements of the Act. This approach would

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32 Canada Revenue Agency Charities Information Letter CIL – 1995 – 007.

33 Canada Revenue Agency Charities Information Letter CIL – 1998 – 025; Canada Revenue Agency Charities Information Letter CIL – 1999 – 016; Canada Revenue Agency Charities Information Letter CIL – 2001 – 003.

34 A portion of the following discussion is based upon Hayhoe Critical supra note 1 at 333-334.

35 *The Convention Between Canada and the United States of America with Respect to Taxes on Income and Capital*, signed at Washington, DC on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, and July 29, 1997.

36 The Canada Revenue Agency has confirmed that any organization which pursuant to Internal Revenue Code section 501(c) (3) is eligible: Canada Revenue Agency Registered Charities Newsletter, Autumn 1996 Special Release; Canada Revenue Agency Charities Information Letter CIL – 1998-020.

be consistent with the recent amendments to the revocation provisions which provide for revocation for *gifts* by a registered charity other than to a qualified donee.[37]

The Canada Revenue Agency, however, has confirmed its view that the treaty provision applies only to gifts by individuals and taxable corporations and that the application of article XXI(6) to a registered charity is precluded by the definition of registered charity in subsection 248(1)[38]. As discussed, this position is not justified on the words of the treaty and is certainly inconsistent with international comity in that a US charity can properly make grants to Canadian charities[39].

Given that the Canada Revenue Agency has disagreed explicitly with the position that US charities are qualified donees, charities wishing to rely on it should do so cautiously. In particular, I might not recommend planning to use this legal position in the context of an entity which needed to fundraise from the public and which would therefore be particularly concerned about being challenged by the Canada Revenue Agency.

However, in the context of a private foundation wishing to fund an American charity, the combination of the *Income Tax Act* and the plain words of the Treaty quite clearly permit this type of grantmaking. Since some private foundations need not be concerned about the possible public fundraising consequences of being challenged by the Canada Revenue Agency, their management may well wish to take the risk and challenge the Canada Revenue Agency on this basis.[40] Another possible approach would be to request confirmation from the Minister of National Revenue acting as competent authority that the interpretation set out above is correct at law.[41] As well, from time to time, I have taken some comfort from the availability of this argument to some of my charitable organization clients which carry on joint activities with American charities under circumstances where I am concerned that the Canada Revenue Agency might challenge the reality of the jointness of the arrangement.

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37 Subsections 149.1(2), (3) and (4).

38 Canada Revenue Agency document no. 9428085, December 22, 1994. On the other hand, Canada Revenue Agency document no. 9728355, February 27, 1998 can be read to suggest that a Canadian registered charity with US source income (which is, of course, tax exempt!) might be able to rely on article XXI(6) to the extent of the US source income. It should be noted that while the US technical explanation to article XXI(6) is silent on the specific argument made above, it explains the provision as one designed to permit Canadian taxpayers to donate to US charities.

39 Jane Peebles, "Here There Be Dragons: Navigating the Waters of Cross-Border Philanthropy," in *University of Miami Institute on Estate Planning* (New York: Mathew Bender, 1997), 7:1-42. at 7:3.

40 Prior to March 23, 2004, the principals of a private foundation taking this approach might have been advised to arrange for the establishment and registration of another private foundation which would be available to receive the assets of the private foundation in the event that the Canada Revenue Agency revoked the registration of the Canadian registered charity making grants to American charities and sought to apply the subsection 188(1) revocation penalty tax. The 2004 Budget limited this type of planning by requiring that a revoked charity may only avoid the revocation tax if it grants its assets to another registered charity more than 50% of the board of which deal at arm's length with each member of the board of the revoked charity: supra note 10 at 354-355.

41 Pursuant to Canada-U.S. Tax Treaty articles III and XXVI. For guidance on the operation of the competent authority process, see Claude Lemelin and Regina Deanehan, "The Competent Authority Process: A Canadian and US Comparative Analysis" in "International Tax Planning," (1998), vol. 46, no. 3 *Canadian Tax Journal*, 657-677 or Arthur B.C. Drache, "Competent Authority Guidelines" (1999), vol. 7, no. 12 *Canadian Not-for-Profit News* 94-95.

V. Foreign Activities by Canadian Registered Charities

The Canada Revenue Agency sets out in some detail in Canada Revenue Agency Guide RC4106: *Registered Charities Operating Outside Canada*[42] the ways in which registered charities can operate. It is obvious that a Canadian registered charity is always free to carry on activities outside of Canada through its own staff or volunteers. As a general rule, if a purpose would be charitable if carried on in Canada, it would be charitable if carried on outside of Canada.[43] On the other hand, there are some categories of charitable purposes which are only charitable if carried out domestically. For example, relieving the Canadian national debt is charitable in Canada, while relieving the national debt of a foreign country would not be charitable.[44] A similar argument can be made that while supporting the Canadian armed forces is charitable ("defence of *the* realm"), supporting the armed forces of another state would not be charitable in Canada.[45]

(a) Public Policy

The Canada Revenue Agency also takes the position in Guide RC4106 that a Canadian registered charity may not carry out foreign activities which violate Canadian public policy. While this position is based upon a solid legal foundation,[46] its application is not always so well founded. In *Canadian Magen David Adom for Israel v. M.N.R.*[47], the Crown took the position that because the Canadian charity allowed certain of its ambulances to be used across the so-called "green line" in the Occupied Territories, it was violating Canadian public policy. The Federal Court of Appeal acknowledged that an entity which violates Canadian public policy would not be charitable in Canada. However, the Court confirmed that the bar for establishing such a violation was extremely high.[48] In order to be a violation of public policy, an activity would have to be illegal by Canadian law[49] or be contrary to some very compelling public pronouncement. In this

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42 <http://www.cra.gc.ca/E/pub/tg/rc4106/README.html>.

43 *MacKenzie v. M.N.R.*, 52 D.T.C. 346 (T.A.B.) and *Re Levy* (1989), 68 O.R. (2d) 385 (C.A.) at 389.

44 Canada Revenue Agency Guide RC4106 *Registered Charities Operating Outside Canada*.

45 On the basis of *Canadian Magen David Adom for Israel v. Minister of National Revenue* 2002 FCA 323 (http://decisions.fct-cf.gc.ca/fct/2002/2002fca323.html). For more discussion of this issue, see Robert B. Hayhoe, "Case Comment: *Canadian Magen David Adom for Israel v. M.N.R.* (2002) 5:1 *International Journal of Not-for-Profit Law* <http:www.icnl.org.journal/vol5iss1/cn_na-canda.htm> (hereinafter "Hayhoe, CMDA Comment").

46 *Everywoman's Health Care Society v. M.N.R.*, [1992] 2 F.C. 52 (C.A.).

47 Supra, note 45.

48 In the "baby derby" case involving a large bequest by an eccentric to the Toronto woman who gave birth to the most children in the next ten years, the Supreme Court of Canada refused to invalidate the bequest on public policy grounds. The Court set out the following test for public policy (*Re Millar*, [1938] S.C.R. 1 at 7):

1. The public policy test must be used "in the interest of the safety of the State or the economic or social well-being of the State and its people as a whole".
2. The doctrine should be invoked only in clear cases, in which the harm to the public is substantially incontestable and does not depend upon the idiosyncratic inferences of a few judicial minds.

49 An activity which is a violation of a foreign law but which is not a violation of Canadian law and which would not be a violation of Canadian law if carried out in Canada, should not be a violation of Canadian public policy. It is easy to list many types of activities which are often carried out abroad by Canadian charities but which are illegal in some jurisdictions: Christian missionary activities, education of girls or promotion of family planning.

case, the fact that Canada had supported various United Nations resolutions condemning the occupation was held to not be a sufficient pronouncement to form the basis of the alleged Canadian public policy.

(b) Operational Guidance

The Canada Revenue Agency has not provided very much guidance on the details of how a Canadian registered charity operating abroad through its own staff should operate.[50] However, the Charity Commission for England and Wales has published a very helpful guide, *Charities Working Internationally*.[51] Although some details of the applicable law may not be the same (particularly since English charities may make grants to foreign charities[52]), the analysis in the English guide is very helpful and should be referred to by Canadian lawyers advising on direct foreign activities by Canadian charities.

(c) Charitable Goods Policy

It may be possible in some circumstances for a Canadian charity to take the position that the transfer of property by it to a foreign charity is not just a gift to the foreign charity but is actually a gift made in the course of the Canadian charity's own charitable activities. The 2002 decision of the Federal Court of Appeal in *Canadian Magen David Adom for Israel v. The Queen*[53] supports this approach.

Canadian Magen David Adom for Israel had its registration revoked for, among other things, sending ambulances to its Israeli sister organization without the support of an agency agreement or joint venture agreement. Canadian Magen David Adom had been registered on materials which made clear that it planned to support its sister organization in this way. In previous Revenue Canada audits, Canadian Magen David Adom had been told that it could rely on an internal Revenue Canada policy known as the "charitable goods policy". This policy essentially took the position that if a Canadian registered charity distributed goods to a foreign charity in a situation where the foreign charity could be relied upon to use them for charitable purposes and where the goods, by their nature, could only be used in charitable activities, then the distribution was an expenditure in the course of the Canadian charity's own activities.[54]

The Charity Commission for England and Wales takes a similar position in *Charities Working Internationally* <http://www.charity-commission.gov.uk/supportingcharities/cwi.asp> at paragraph 86.

50 RC4106, supra note 42 provides limited details.

51 Supra, note 49.

52 C.R.J. Marlow, "United Kingdom" (1997), 37*European Taxation* 366 at 368.

53 Supra, note 45.

54 The details of the policy are reproduced in the Court's decision (supra note 45 at para. 17) as follows:

Equally acceptable are transfers of goods and services that are directed to a particular use by the very nature of the goods and services so transferred. Examples of such transfers include:

- transfers, by a research organization, of books and scientific reports to anyone interested (including foreign governments, libraries, schools, etc.),
- transfers of books – on a subject of particular interest to an educational charity – to public libraries in major cities all over the world,
- transfers of medical supplies to a refugee camp,

Unfortunately, the Federal Court of Appeal avoided the issue of the correctness of the charitable goods policy.[55] The Court decided that since one of the ambulances which were sent to Magen David Adom (the Israeli sister organization) was eventually transferred to the Israeli Defence Force, Magen David Adom was not an appropriate recipient under the charitable goods policy (the support of a foreign armed force not being charitable in Canada).

This charitable goods policy had never been communicated to the public. Indeed, a few years before the Canadian Magen David Adom decision, I had suggested such an approach to a very senior policy officer at Charities Directorate and was told that this approach was not possible. Even after the Canadian Magen David Adom decision, there is no mention of a charitable goods policy among the plethora of new Charities Directorate policy documents now posted on the Canada Revenue Agency's website.[56] I have asked Charities Directorate staff about the present application of the policy and have not received a clear response.

My view is that the charitable goods policy is good law. The recent amendments to the revocation provisions in the Act support the existence of a charitable goods policy. The Act is now explicit in permitting a registered charity to make a gift other than to a qualified donee in circumstances where the gift is still part of the charitable activities of the giving charity.[57]

Wholesale distribution of goods which can reasonably be used only in charitable activities to another charitable organization is itself an activity in pursuit of a charitable purpose[58]. For example, the distribution by a Canadian registered charity of certain relief supplies to a Swiss charity for use in the Swiss charity's third world disaster relief program is a charitable activity of the Canadian charity. Similarly, a Canadian organization's printing of scriptures and providing them free of charge to a foreign religious organization for ultimate distribution by the foreign charity[59] is also clearly a charitable activity of the Canadian charity. Nonetheless, serious thought should be given to the possible reaction of the Canada Revenue Agency to the explicit use of this approach.

- transfers of good, blankets, etc. to a charity coping with a natural disaster,
- transfers of drugs, medical equipment, etc. to poorly equipped hospitals,
- transfers of personnel to schools or hospitals (on loan).

55 "A second primary question is whether the charitable goods policy is valid, in the sense of being well founded in law. The answer is not clear. However, as the point was not argued, I am prepared to assume, without deciding, that a legal justification could be found for the policy. Given that assumption, the issue is whether the Minister erred in finding that the charitable goods policy does not apply to the appellant's provision of ambulances and related equipment to MDA." Supra note 45 at para. 70.

56 www.cra.gc.ca/tax/charities/glossary-e.html

57 Otherwise subsections 149(2), (3) and (4) would not be necessary.

58 This position is supported by the analysis of the interplay between "charitable activities" and "charitable purposes" set out by the Supreme Court of Canada in *Vancouver Society of Immigrant and Visible Minority Women v. Canada (Minister of National Revenue)*, 99 D.T.C. 5034.

59 I once suggested such an arrangement to the Canada Revenue Agency Charities Directorate and was told that there was always a chance that the scriptures provided would be used as toilet paper! Not only was the suggestion so offensive that I decided not to convey it to my client, but it was also irrelevant since the scripture volumes could just as easily have been desecrated if they were distributed to the public by staff of the Canadian charity.

VI. Contractual Arrangements between Canadian and Foreign Charities

The Canada Revenue Agency accepts that a Canadian registered charity will be, as a matter of law, carrying out its own activities if it engages a foreign agent or if it enters into a joint venture arrangement with a foreign charity or if it enters into a joint partnership arrangement with a foreign charity.[60] Each of these possible types of arrangements gives rise to its own problems.

While the Canada Revenue Agency also devotes some time in RC4106 to the use of foreign contractors as an appropriate way of carrying out foreign activities, little should be taken from the reference to foreign contractors. After all, the examples given are of purchases of goods and services in the ordinary course of the Canadian charity's activities – the fact that the contractors are outside of Canada should have little impact on the Canadian charity. In fact, the specific reference to "contractors" could imply special status which is not really warranted[61].

VII. Agency Relationships

As a matter of common law, a person may appoint an agent[62] to act on the person's behalf. A principal is legally responsible for the activities of an agent and an agent may bind a principal.

(a) Agency Law

The genesis of agency is the appointment of the agent by the principal. While the appointment of an agent is typically recorded in a written agreement, the appointment of an agent is not a matter of contract. For example, there is no need for consideration in the appointment of an agent – there is no legal principle which operates to prevent gratuitous agency.[63]

Furthermore, the essence of the agency relationship is that the agent acts on behalf of the principal. The legal result of the principal's responsibility for the agent's activities is not dependant in any way upon the principal maintaining control or direction over the activities of the agent. Thus, it should be possible for a Canadian registered charity to appoint an agent and grant that agent very significant authority over the charitable activities which the foreign agent carries out on behalf of the Canadian charity. Indeed, the Canada Revenue Agency is willing to accept that a Canadian registered charity may carry on foreign activities (or activities in Canada) by retaining an agent.[64] However, the Canada Revenue Agency takes the position that the Canadian registered charity is required to maintain direction and control over its agent's activities.[65]

Given that the purpose of using an agency relationship is only to make the activities of the agent, as a matter of law, the activities of the principal, there is no tax law basis for this direction and

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60 RC4106, supra note 42.

61 David Amy, "Foreign Activities by Canadian Charities" (2000), 15 *The Philanthropist* 41 (hereinafter "Amy Foreign") at 47.

62 The common law of agency is relatively complicated. For more detail on the law of agency, see G.H.L. Fridman, *The Law of Agency* (Toronto: Butterworths, 1996).

63 Fridman, supra note 61 at 55.

64 RC4106, supra note 42.

65 Canada Revenue Agency Charities Information Letter CIL – 1994 - 001.

control requirement. Put another way, an agent's activities are the activities of the principal even if the principal maintains little or no practical control over the agent.[66] Unfortunately, in The Canada Committee for the *Tel Aviv Community Foundation v. The Queen*[67], the Federal Court of Appeal accepted Revenue Canada's assertion that direction and control was necessary in an agency relationship.[68] However, the only authority which appears to have been relied upon by the Federal Court of Appeal was the then Canada Customs and Revenue Agency Guide RC4106 which so required. The Federal Court of Appeal did not consider any of the binding agency law authorities which would have driven it to the contrary conclusion.

Of course, notwithstanding the lack of authority for the position of the Canada Revenue Agency and the Federal Court of Appeal, registered charities entering into agency relationships must consider the need for direction and control over the activities of the foreign agent in order to avoid Canada Revenue Agency compliance action. In fact, even in Guide RC 4106, the specific degree of direction and control which the Canada Revenue Agency suggests for an agency relationship is that the registered charity, before entering into the agency relationship have a clear idea of the charitable project which it wishes to achieve and how it wishes the project to be achieved. It therefore appears to be possible to enter into an agency relationship where the controls that would be exercised can be limited to the identification of the project to be covered and to initial direction on how the project is to be carried out. It does not appear to be generally necessary in the context of an agency agreement for the Canadian registered charity to be engaged in day to day governance of the project.[69] It is this absence of a requirement for operational control over the project which makes the agency relationship attractive in many circumstances.

It is important, though, to understand the implications of this operational control, given that the liability for an agent's torts flows through to the principal. Particularly in a case where the agent is operating without significant day to day control, this can be dangerous.[70]

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66 The requirement of agency law is better phrased as a requirement that the principal have authority over the agent: Fridman, supra note 62 at 157-158, the distinction is important because "direction and control" must be exercised in order to exist, while "authority" exists by virtue of being acknowledged.

67 *Canadian Committee for the Tel Aviv Foundation v. Canada*, 2002 FCA72 (http://decisions.fct-cf.gc.ca/fct/2002/2002fca72.html).

68 Robert B. Hayhoe, "Case Comment on *Canadian Magen David Adom for Israel v. Minister of National Revenue"*, 2002 FCA 323 (2002), 4:5 *International Journal of Not-for-Profit Law* (hereinafter "Hayhoe, Tel Aviv Comment").

69 Canada Revenue Agency Charities Information Letter CIL – 1997 - 003 acknowledges that the degree of control required is an agency context is considerably less than required in the context of a joint ministry agreement (in recognition of the fact that joint venture agreements were first applied in this context by Christian organisations which referred to the agreements as joint *ministry* agreements).

70 Having said that, for charities using agents in jurisdictions of poorly developed legal systems, the likelihood of a financial claim being brought against the Canadian charity is very small and the likelihood of significant damages may be smaller still. This is not to dismiss the moral responsibility which Canadian charities operating abroad have to protect those whom they serve.

(b) Agency Agreement Details

The Canada Revenue Agency has provided some detail in Guide RC4106 on what it expects to see covered in an agency agreement or other agreement designed to permit indirect foreign activities. I will reproduce and annotate the list of the Canada Revenue Agency's requirements:

- *the charity has obtained reasonable assurance before entering into agreements with individuals or other organizations that they are able to deliver the services required by the charity (by virtue of their reputation, expertise, years of experience, etc.);*

This approach is a sensible one. However, it can be very difficult to apply in particular situations. For example, in a disaster relief situation, it is frequently the case that there are no suitable trustworthy local individuals or organizations who can be hired as agents. At the same time, it may be impossible for Canadian staff of the Canadian charity to operate in the area. It should not be suggested that as a result a Canadian charity may not engage in disaster relief in the area. Instead, it may be appropriate for the Canadian registered charity to consider the risk of shrinkage as a result of the use of untrustworthy agents to be something which, despite the taking of appropriate safeguards, is inevitable.[71]

- *all expenditures will further the Canadian charity's formal purposes and constitute charitable activities that the Canadian charity carries on itself;*

- *an adequate agreement is in place (we recommend a written agreement containing the minimum elements outlined below);*

In my view, a written agreement should always be used. Since the essence of an agency relationship is the appointment, it would certainly be possible to have the verbal appointment of an agent.[72] However, the details of the agent's appointment need to be provided for. Indeed, the only specific argument which I have seen made for not using a written agency agreement is that if the agency relationship is not recorded in writing, it may be possible at a later date to deny its existence in the event of a civil suit arising out of the conduct of the agent.[73] With respect, this approach misapprehends the nature of the potential liability which can arise from the activities of an agent. Liability for an agent's activities is considered generally to be limited to liability for activities which occur during the course of the agency relationship.[74] If the agency relationship is not recorded in writing, it will be virtually impossible to argue that any particular activity is not within the scope of the agency relationship. However, if the agency agreement is drawn carefully, it may be possible to limit the scope of the agency relationship to only those activities which are less risky.

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71 Indeed, the Charity Commission for England and Wales acknowledges this in *Charities Working Internationally*, supra note 49.

72 Indeed, agency can be implied; Fridman, supra note 62 at 55-61.

73 Bromley, supra note 1 at 36:21.

74 Fridman, supra note 62 at 315.

Furthermore, it is also possible (and indeed advisable) to build limitation of liability clauses[75] and indemnity[76] provisions into agency agreements. My typical approach is to provide that the foreign charity shall fully indemnify the Canadian charity for all liability arising as a result of the agency relationship. While this may be cold comfort in the case of a small third world NGO, it can provide significant protection in the case of a large American charity. The theory upon which I base this approach is that the foreign charity otherwise expects to receive a grant from the Canadian charity (where all liability for the eventual use of the grant money would rest on the foreign charity). The foreign charity should not be put in a better liability position by virtue of the agency relationship which exists only to permit the Canadian charity to comply with its tax requirements.

- *the charity provides periodic, specific instructions to individuals or organizations as and when appropriate;*

As discussed above, the degree of direction and control appropriate may vary in different circumstances. It is my view that in many cases involving agency, the necessary authority can be demonstrated at the beginning of a project through a project budget process and does not necessarily require detailed ongoing management involvement in a project.

- *the charity regularly monitors the progress of the project or program and can provide satisfactory evidence of this to us (see the next section on books and records); and*

- *where appropriate, the charity makes periodic payments on the basis of this monitoring (as opposed to a single lump sum payment) and maintains the right to discontinue payments at any time if it is not satisfied.*

Canada Revenue Agency Guide RC4106 further provides that both agency and joint venture agreements should typically include at least the following information:

- *names and addresses of all parties;*

- *the duration of the agreement or the deadline by which the project must be completed;*

- *a description of the specific activities for which funds or other resources have been transferred, in sufficient detail to outline clearly the limits of the authority given to the recipient to act for the Canadian charity or on its behalf;*

As discussed above, it is important to consider the potential liability risk of particular activities in choosing which activities on the foreign charity should be funded through an agency agreement. This is not to say, however, that a Canadian registered charity is limited to funding narrowly defined projects when the Canadian registered charity uses

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[75] which, of course, bind only the parties to the agency, not third parties who have suffered harm.

[76] Particularly given that the default rule is that a principal must indemnify an agent, absent agreement to the contrary: Fridman, supra note 62 at 201-203.

an agency agreement. It is certainly possible to put in place an agency agreement whereby a foreign charity agrees to carry on all of its activities on behalf of a Canadian registered charity. In a broad agency situation such as this, the degree of direction and control which would be expected by the Canada Revenue Agency would likely be relatively substantial.

There is also no reason in principle why the sponsorship of a project through an agency arrangement needs to be limited to a project which is fully funded by the Canadian registered charity. Since, as described above, agency is created by an appointment, not by a contract with consideration, there is nothing to prevent a Canadian registered charity from hiring a foreign charity as an agent to carry on some particular project on its behalf even though the project will be partly funded by the principal (the Canadian registered charity) and partly funded by the agent (the foreign charity).

- *provision for written progress reports from the recipient of the Canadian charity's funds or other resources, or provision for the charity's right to inspect the project on reasonably short notice, or both;*

It is my view that in order for the Canadian charity and its directors or trustees to meet the obligations imposed on them by trust law, written progress reports are almost mandatory.[77] These written reports should contain significant operational and financial detail. Even with such reports, an agency agreement should also provide a right for the Canadian registered charity to inspect the project and all related records at any time on short notice. In fact, when such inspections take place, the staff of the Canadian registered charity should be instructed to keep detailed records on their return to Canada. The only circumstances in which I have ever prepared agency agreements which do not provide for written progress reports are situations involving activities which are, although not a violation of Canadian public policy, illegal in a country in which they are carried out. In such circumstances, I would instead provide for regular project visits either by Canadian staff or by others (perhaps employed by an affiliate in another country) with provision for the preparation of detailed reports from memory by the project visitors upon their exiting the dangerous situation.

- *provision that the Canadian charity will make payments by instalments based on confirmation of reasonable progress and that the resources provided to date have been applied to the specific activities outlined in the agreement;*

- *provision for withdrawing or withholding funds or other resources at the Canadian charity's discretion;*

It is likely sufficient in order to meet the requirements of the Canada Revenue Agency if the agency agreement provides that the principal may withhold funds upon an event of default by the agent. However, my practice is to provide that notwithstanding that funding is provided for in the project budget, the Canadian principal is under no obligation to provide any funds and may withhold any funds without cause. In my view,

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[77] As the Charity Commission for England and Wales concludes in *Charities Working Internationally*, supra, note 49 at para. 44.

it is important that the ability to withhold funds be made without cause. Otherwise, the Canadian registered charity could find itself in a situation where it would be required to show cause in a foreign and possibly corrupt court.

- *provision for maintaining adequate records at the charity's address in Canada;*

- *in the case of agency agreements, provision for the Canadian charity's funds and property to be segregated from those of the agent and for the agent to keep separate books and records; and*

In recent years, the Canada Revenue Agency has been taking a relatively hard line on this issue. In one case of which I am aware, a Canadian registered charity did not insist on segregated bank account and did not receive well segregated accounting records with the result that a Canada Revenue Agency auditor sought to obtain all of the accounting records of the agent (first through a requirement issued pursuant to the *Income Tax Act* against the Canadian charity, then through an IRS requirement issued pursuant to the treaty to the Canada-US Tax Convention against the agent). However, notwithstanding the RC4106 segregation requirement, the Canada Revenue Agency has issued a charities information letter in which it agrees that in limited circumstances it may not be necessary to keep an actual segregated bank account if the segregation in accounting records is clear.[78] This second position is a more sensible one and is more clearly consistent with the legal nature of an agency relationship.

- *the signature of all parties, along with the date.*

(c) Multi Agency Agreement

In some circumstances, a Canadian charity wishes to fund particular projects which are carried on by sister organizations in other countries. However, different aspects of the particular activity may be carried on by staff members of different sister organizations. In such circumstances, it is, of course, possible to use a joint venture arrangement (as described below). However, in some circumstances, it is also possible to use an agency agreement.

For example, I have developed an agency agreement whereby a Canadian registered charity hires one of its sister organizations to provide staff members who will complete a foreign relief and development project. However, because the record keeping for the foreign project is typically not done by the sister organization which employs the staff but is done either by another sister organization or by an international umbrella organization, it may be possible to have a multi-party agreement whereby the umbrella organization or the other sister organization, although not constituted an agent of the Canadian registered charity, will be a party to the agency agreement and will agree to provide the required reports. Indeed, in a more complicated situation, it may even be necessary to have one agency agreement executed by all of the sister organizations with an amendable schedule whereby different sister organizations will perform either as agents or as reporters in different projects. Although, of course, this provides no guarantee of similar future

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[78] Canada Revenue Agency Charities Information Letter CIL – 1997 – 003.

treatment[79], I recently prepared just such an agreement in response to a Canada Revenue Agency audit of a new client. The Canada Revenue Agency accepted this approach as part of the audit follow-up.

(d) Intellectual Property Issues in Agency Agreements

Since, under the agency arrangement, the Canadian charity is, as a matter of law, actually carrying on the activities in the foreign jurisdiction, it is important to consider the implications that an agency arrangement may have on trademark protection. Since, as a general rule, a trademark is a right to exclusive use in a jurisdiction of a mark in connection with particular wares and services, it is important for the holder of a registered mark to ensure that only the registered holder uses the mark in the particular jurisdiction (either directly or through licensees). A foreign charity which holds a registered trademark in its jurisdiction, should be concerned about possible dilution of its trademark protection if it allows a Canadian registered charity to, through hiring the foreign charity as an agent, effectively use the foreign trademark in the foreign jurisdiction[80]. If as a matter of local law, this is a real concern, it may be appropriate for the agency agreement to either include a licensing clause or be supplemented with a separate licence agreement whereby the Canadian registered charity agrees that any use of the trademark in the foreign jurisdiction in the context of the agency relationship is a use which is licensed from the holder of the registered trademark.

VIII. Joint Venture Arrangements

In Guide RC4106, the Canada Revenue Agency accepts that a Canadian registered charity may carry on foreign activities jointly with a foreign charity or a number of foreign charities. The theory upon which this is based is that a joint venture is a pooling of resources whereby a number of legal persons carry on a particular set of activities on a joint basis. The legal result of this pooling is that the activity becomes the activity of all.[81] Many of the issues discussed above under the agency agreement heading are also relevant in the context of a joint venture arrangement.[82] However, the Canada Revenue Agency also suggests that the following additional items need to be provided for in a joint venture agreement. Please note that the following list only constitutes a list of the types of factors looked for by the Canada Revenue Agency in examining a joint venture arrangement. In my experience, it would be relatively rare for any joint venture arrangement to have all of these factors[83].

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79 See Robert B. Hayhoe, "Canada Customs and Revenue Agency Charities Audits" (2003), 17 *The Philanthropist* 38 (hereinafter "Hayhoe Audit") for a discussion of Canada Revenue Agency's audit approach.

80 *Hughes on Trademarks* (Toronto, Butterworths: looseleaf) at 569 – 571-2.

81 For more detail on the law of joint ventures (primarily in a commercial context but generally relevant here), see Blair P. Dwyer, "A Comparison of the Income Tax Implications of Using a Partnership or a Joint Venture" in *Corporate Tax Planning in a Changing Business Environment*, 1994 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1994), 10:1-30

82 For a very complete discussion of the use of joint ventures by a lawyer with a great deal of experience in implementing them in the context of Canadian registered charities carrying on activities abroad, see Amy Foreign, supra note 61 at 47-52.

83 As acknowledged by Canada Revenue Agency Charities Information Letter CIL-1998-027.

- *presence of members of the Canadian charity on the governing body of the joint venture;*

As discussed in more detail by others[84], in addition to having members on the governing body of the joint venture, these members should have representation which is proportionate to the overall contribution of the Canadian registered charity. Since relative contributions of joint venture members varies from time to time, under this approach, voting power is required to be modified from time to time.[85] This is complicated and in my view not always necessary. Instead, I generally recommend that clients consider a joint venture governance model where a positive decision on any matter requires the majority vote of both the whole governing body and of the participants appointed by each of the members. This effectively gives each of the participating organizations a veto. If this is not too disruptive to efficient decision making, it prevents the need to redo voting calculations from time to time and also provides significant support to the legal argument that the Canadian registered charity has at all times maintained very significant direction and control over the joint venture.

Despite what I have said above about the Canada Revenue Agency list being only a list of factors, in my view this factor is of overwhelming importance such that the Canadian registered charity should always have at least a proportionate level of voting control.

- *presence in the field of members of the Canadian charity;*

- *joint control by the Canadian charity over the hiring and firing of personnel involved in the venture;*

- *joint ownership by the Canadian charity of foreign assets and property;*

- *input by the Canadian charity into the venture's initiation and follow-through, including the charity's ability to direct or modify the venture and to establish deadlines or other performance benchmarks;*

- *signature of the Canadian charity on loans, contracts, and other agreements arising from the venture;*

- *review and approval of the venture's budget by the Canadian charity, availability of an independent audit of the venture and the option to discontinue funding;*

- *authorship of procedures manuals, training guides, standards of conduct, etc., by the Canadian charity; and*

- *on-site identification of the venture as being the work, at least in part, of the Canadian charity.*

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[84] Amy Foreign, supra note 61.

[85] Amy Foreign, supra note 61 at 50.

IX. Cooperative Partnerships

In RC4106, the Canada Revenue Agency discusses how a Canadian registered charity may operate jointly with others through a co-operative partnership. The Canada Revenue Agency distinguishes a co-operative partnership from a joint venture arrangement by the fact that in a co-operative partnership[86], different parties take responsibility for a particular aspect of a charitable project which is being carried on. The example given by the Canada Revenue Agency in RC4105 is that of a number of entities (some of which may be for profit) which join together to provide medical care in a particular community. In that circumstance, the Canada Revenue Agency agrees that the Canadian registered charity could take responsibility for only one aspect of the project. One example which has been commented on in the past is that of a Canadian registered charity paying for and providing to a foreign hospital a piece of diagnostic equipment which will be used in the foreign hospital by staff of the foreign hospital[87].

What distinguishes a co-operative partnership arrangement from a joint venture arrangement is that a co-operative partnership is not designed to address the "own activities" requirement that limits a Canadian registered charity to only carrying on foreign activities as its own activities. The contribution of property or other resources to a co-operative partnership is the use of the charity's resources for its own activities regardless of whether there is an agreement.[88] Instead, the use of a co-operative partnership agreement is only a matter of buttressing the evidence or records of the charitable activities which are carried on by the Canadian registered charity.

X. Property Transfers to Foreign Charities

In RC4106, the Canada Revenue Agency discusses property transfers in a foreign country. The position of the Canada Revenue Agency is that a Canadian registered charity should wherever possible insist on maintaining ownership and control over all capital assets which are funded with the resources of the Canadian registered charity.[89] However, in addition to these clear cases, the Canada Revenue Agency also acknowledges that Canadian registered charities sometimes operate in countries where foreign ownership of real property is not permitted. As a result, the Canada Revenue Agency acknowledges that in these restricted situations, it can be appropriate to enter into a title-holding arrangement with a local charity or government body if the Canadian registered charity can be certain that the property will be used for charitable purposes. This is a very useful and helpful concession on the part of the Canada Revenue Agency. The Canada Revenue Agency also acknowledges in RC4106 that, in order to empower

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86 Which is, of course, not really a partnership because it does not constitute the carrying on of business in common with a view to a profit: *Partnership Act*, R.S.O. 1990, c. P.5.

87 Amy Foreign, supra note 61 at 52.

88 Unlike in the case of a joint venture or agency relationship where, in order to meet the own activities test, it is necessary to either appoint an agent or agree with a joint venturer.

89 The Canada Revenue Agency acknowledges that in the following situations it is clearly appropriate for a Canadian registered to transfer assets abroad:

- the transfer of these assets in itself constitutes a charitable activity, for example, offering food to the hungry, awarding a scholarship to a student, providing housing to the homeless, or giving the poor the equipment they need to become self-sufficient; or
- the assets are sold for their fair market value; or
- the assets are transferred to a qualified donee.

foreign communities involved in development projects, it may in some circumstances be appropriate for a Canadian registered charity to transfer ownership of assets in these types of projects.

Nonetheless, in order to avoid dealing with the property ownership issue if possible, I typically suggest to my Canadian registered charity clients that in choosing projects to sponsor, it is always better to provide operating funding. In fact, if a Canadian registered charity is approached with a capital funding proposal by a foreign charity, it may wish to suggest that it will cover the operating requirements of the foreign charity (despite the fact that the foreign charity does not see itself as needing help with operating requirements) in order to free up the current operating funding of the foreign charity to be used for the capital project.

XI. Royalties and Membership Fees

It is clearly proper for a registered charity to pay licensing fees for intellectual property which is owned by another entity. In RC4106, the Canada Revenue Agency acknowledges that a Canadian registered charity which is an offshoot of another organization with headquarters in another country may be obliged to pay money to the parent organization for various things such as professional training, accounting services, literature or trademarks and copyright.

The general position of the Canada Revenue Agency is that payments to a foreign charity must be proportional to the benefit or value received. However, the Canada Revenue Agency is willing to accept that a Canadian charity which pays annual fees to an affiliated organization of less than the lesser of $5,000 and 5% of the charity's expenditures in the year is receiving value. Above these thresholds, the Canadian registered charity will be obliged to show (perhaps through a formal written agreement) that it is receiving value for money.

It is my experience that few charities rely on this principle to any great extent. This is unfortunate. There are relatively clear transfer pricing rules developed in the context of multinational corporation which can provide significant guidance in this area and which might support quite significant payments by a Canadian charity to its foreign parent.[90] Although I am not an intellectual property valuator, if a foreign charity which fundraises broadly from the public and already has wide international brand recognition (including in Canada) licenses its name and other intellectual property assets to a newly established Canadian charity with no fundraising history, it would appear that any significant short term fundraising success enjoyed by new Canadian charity would be due to the licensed intellectual property and could quite properly be paid to the foreign charity in the form of royalties.

XII. Record Keeping[91]

Although I have already commented in passing on certain recordkeeping issues, it is also useful to have a more systematic outline of what records need to be kept. Section 230(2) of the Act is the primary record keeping obligation for a registered charity. It requires that:

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[90] For example, see Canada Revenue Agency Information Circular 87-2R *International Transfer Pricing*.

[91] The following outline is based very closely upon the recordkeeping sections in Hayhoe Audits, supra note 79 at 41-42.

> Every registered charity and registered Canadian amateur athletic association shall keep records and books of account at an address in Canada recorded with the Minister or designated by the Minister containing
>
> a) information in such form as will enable the Minister to determine whether there are any grounds for the revocation of its registration under this Act;
>
> b) a duplicate of each receipt containing prescribed information for a donation received by it; and
>
> c) other information in such form as will enable the Minister to verify the donations to it for which a deduction or tax credit is available under this Act.

The scope of paragraph 230(2)(a) is less clear.[92] Essentially, this provision requires that a charity keep sufficient records to demonstrate that all of its activities have a charitable purpose. This requires that the charity exercise considerable discretion in deciding what records to keep. The relevant Canada Revenue Agency guides provide little assistance on this issue.[93]

What records should then be kept of foreign activities? The answer depends on the context, but charities should be advised to err on the side of keeping more records rather than less.

In some circumstances, keeping records may not be possible. For example if a Christian religious charity operates in a country where Christianity is illegal, it may endanger lives if any of its records can be intercepted in that country. While we hope that the Canada Revenue Agency would be understanding if fewer records were available in such a circumstance, there is no Canada Revenue Agency policy to that effect. As discussed above, I have advised clients in these circumstances to rely on live field visits by Canadian staff members who then write field reports from memory upon return to Canada.[94] Another example of a situation where traditional recordkeeping is impossible is in sending financial support to a charity's own staff in a country with no functioning modern banking system.[95]

The Act requires that a charity's records be kept in Canada. This is not a mere technicality. In the *Tel Aviv Community Foundation Case*[96], one of the reasons which supported the revocation of its charitable registration was that it had not been diligent in following up with its agent to make sure that the reports contemplated by the agency agreement were actually sent. As a result, the Federal Court of Appeal was prepared to conclude that the charity did not maintain the required records in Canada. It is for this reason that contractual arrangements with foreign charities should provide for regular reporting and for the foreign charity to periodically send copies of back-up records to the Canadian charity.

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92 Arthur Drache, "Charity Record Retention" (2002), 10:9 *Canadian Not-for-Profit News* 65 at 70.

93 Canada Revenue Agency Guide *Registered Charities and the Income Tax Act*, RC4108.

94 As appears to be contemplated by RC4106, supra note 42

95 The Charity Commission for England and Wales suggests in *Charities Working Internationally*, supra note 49 that it may be appropriate to use informal money chargers. However, the Commission confirms in *Charities and Terrorism* Operational Guidance OG-96 <www.charity-commission.gov.uk/supprtingcharities/ogs/g096, asp> that its general view is that the hawala money transfer system should not be used.

96 Supra note 67.

It should be noted that subsection 230(4.1) renders electronic data acceptable[97] as a general matter. I have therefore suggested to clients dealing with sophisticated foreign charities that they should seek to obtain periodic electronic copies of the foreign charities accounting records. Unfortunately, the Canada Revenue Agency's position is that remote electronic access from a terminal in Canada is not considered to be the keeping of constitute records in Canada.[98] While it is possible to obtain permission from Canada Revenue Agency for a registered charity[99] to keep records outside of Canada,[100] I am not aware of any charities which have sought or received such permission.[101]

XIII. Terrorism

Although terrorism is not a purely foreign issue, no discussion of foreign activities by Canadian registered charities would be complete without an outline of the rules designed to prevent Canadian charities from supporting terrorism. This paper will therefore provide background on this issue.[102]

In response to September 11, 2001 and prior terrorist fundraising situations, the federal government introduced Bill C-16, the *Charities Registration (Security Information) Act* (the "Security Act"). It provides as follows:

> The Minister and the Minister of National Revenue may sign a certificate stating that it is their opinion, based on security or criminal intelligence reports, that there are reasonable grounds to believe
>
> a) that an applicant or registered charity has made, makes or will make available any resources, directly or indirectly, to an entity that is a listed entity as defined in subsection 83.01(1) of the Criminal Code;
>
> b) that an applicant or registered charity made available any resources, directly or indirectly, to an entity as defined in subsection 83.01(1) of the Criminal Code and the entity was at that time, and continues to be, engaged in terrorist activities in support of them; or
>
> c) that an applicant or registered charity makes or will make available any resources, directly or indirectly, to an entity as defined in subsection 83.01(1) of the Criminal Code and the entity engages or will engage in terrorist activities as defined in that sub-section or activities in support of them.

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97 See the detailed discussion of electronic records in Canada Revenue Agency Information Circular 1C78-10R3 *Books and Records Retention/Destruction* (http://www.ccra-adrc.gc.ca/E/pub/tp/ic78-10r3ic78-10r3-e.html).

98 Ibid.

99 As suggested in Knechtel, supra note 1 at 28:24.

100 Subsection 230(2).

101 Likely because the Canada Revenue Agency will only grant permission if the entity making the request agrees to pay travel expenses for Canada Revenue Agency auditors: Walter A. Szyc, CA, "Books and Records in An Electronic Age," *1998 Ontario Tax Conference*, (Toronto: Canadian Tax Foundation, 1998), 14:1-13.

102 The following outline is based very closely upon the terrorism section in Hayhoe Audits, supra note 79 at 54-56.

Upon the issuance of a certificate for the reasons described above, the Solicitor General (Canada's chief law enforcement officer, who is the "Minister" referred to in the Security Act) must bring the certificate before a judge for review. The Security Act provides for a secret hearing of the evidence against the charity without even the charity or its counsel being permitted to be present if the judge determines that disclosure to the charity or its counsel would injure national security or endanger the safety of any person.

After the hearing, the judge can revoke or deny charitable registration. The decision of the Judge in the matter is final and not subject to appeal. However, it is possible for an organization which has been refused charitable registration or which has had its registration revoked on the ground that it funds terrorism, to reapply to the Canada Revenue Agency for registration on the ground that the reasons for the issuance of the original certificate are no longer valid.

It is obvious that the procedure described above is not consistent with the common law traditions of full disclosure and open justice. The Canada Revenue Agency has indicated that in the post-September 11, 2001 context, the procedural approach described in the Security Act is not a violation of fundamental freedoms to which the Charter of Rights would apply.[103] Since a court challenge is inevitable, time will tell.

Leaving aside procedure, one serious concern which remains is that the Security Act provides for the denial or revocation of registration for an organization which indirectly makes funds available to a terrorist organization. Since there is no explicit knowledge requirement in this portion of the Security Act, an organization such as a relief organization which provided food or medical aid in a war zone could potentially be found to have made resources available indirectly to a terrorist organization. The portion of the Security Act which criminalizes fundraising for terrorism provides that allowing resources to be used for terrorism is only a criminal offence if done "wilfully and without lawful justification or excuse". This modifier would provide a criminal law defence for an organization which inadvertently permitted its resources to be used for the benefit of a terrorist organization. There is no such explicit qualifier in the charities registration portion of the Security Act, although it is to be hoped that judges applying the Security Act would imply one.

Charities and their advisors have taken a number of approaches to the Security Act. Some advisors have suggested that pre-existing law deals adequately with the issue so the Security Act should be scrapped.[104] A number of other advisors[105] as well as some umbrella organizations[106] have suggested that the current anti-terrorism provisions are an appropriate response in a post-September 11 world and that, at least in the short term, it is appropriate to rely on the assurances

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[103] "The New Anti-Terrorism Law: Impact on Charities," (Spring 2002) 12 *Canada Revenue Agency Registered Charities Newsletter* (http://www.Canada Revenue Agency-adrc.gc.ca/tax/charities/newsletters/news12-e.html).

[104] The best known proponent of this view is Terrance Carter whose law firm sponsors the internet domain http://www.antiterrorismlaw.ca which provides links to various of articles which comment on the Security Act.

[105] For example, see David Amy, "The Impact of Anti-Terrorism Legislation on Charities," in Working Together, *2002 Canadian Council of Christian Charities Annual Conference* (Ontario: Canadian Council of Christian Charities, 2002) (hereinafter "Amy Terror") or even Arthur Drache, "C-36 Amendments" (2001), 9:12 *Canadian Not-for-Profit News* 89 at 89.

[106] See references to statements by the Canadian Centre for Philanthropy and the Canadian Jewish Congress in Amy Terror, supra note 105.

of the Canada Revenue Agency that it intends to interpret the anti-terrorism provisions in a sensible manner.[107] My view leans toward the second of these two approaches although the Security Act as drafted certainly could be misused; their application should be carefully monitored.

On a cautious approach, many charities should be concerned about the implications of the Security Act. Charities which work overseas (particularly ones which do relief and development work) need to be cautious. Some activities (particularly ones carried out through foreign agents) should only be carried out after careful due diligence[108] or even after obtaining specific pre-clearance from the Canada Revenue Agency.[109]

XIV. Canada Revenue Agency Audit Approach[110]

The approach of the Canada Revenue Agency to arrangements between Canadian registered charities and foreign entities has tightened considerably in recent years. As a result, there have been two recent decisions of the Federal Court of Appeal which denied revocation of registration appeals brought by charities which had seen their registration revoked for non-compliance involving foreign activities. The first of these was the *Committee for the Tel Aviv Foundation v. The Queen*[111] and the second recent case dealing with foreign activities is the *Canadian Magen David Adom for Israel* case.[112] These cases are instructive as descriptions of the Canada Revenue Agency's audit approach.

(a) The Tel Aviv Case

In the *Tel Aviv Community Foundation* case[113], Revenue Canada had audited the Canadian charity (the "Committee") on a number of previous occasions and had consistently flagged the failure to control foreign activities carried out by the Tel Aviv Community Foundation. In facts, in 1995 Revenue Canada even threatened to de-register the Committee because it had violated the terms of its agency agreement with the Tel Aviv Community Foundation since the Committee could not demonstrate control of funds expended by its agent and did not have proper reports from its agent. To avoid de-registration after the 1995 audit, the Committee undertook to "conform strictly to the requirements of Revenue Canada, including the specific provisions of the agency agreement, which is still in force and effect". In 1999, the Canada Revenue Agency

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[107] As set out in "The New Anti-Terrorism Law: Impact on Charities," (Spring 2002) 12 *Canada Revenue Agency Registered Charities Newsletter* (http://www.Canada Revenue Agency-adrc.gc.ca/tax/charities/newsletters/news12-e.html).

[108] See Amy Terror, supra note 105 or Terrance Carter, "Charities Need to Comply with Anti-terrorism Act," [April 5, 2002] *Lawyer's Weekly* for compliance checklists. For a more detailed discussion of due diligence issues, see Terrance Carter, "Charities and Compliance with Anti-terrorism Legislation" in *Estates and Trusts Forum 2002* (Toronto, Law Society of Upper Canada: 2002).

[109] Which I understand to be available in some circumstances.

[110] The following outline is based very closely on the Foreign Activities/Grantmaking section in Hayhoe Audits, supra note 79 at 51-53.

[111] Supra note 67. The discussion herein of this case is based in part upon Hayhoe Tel Aviv Comment, supra note 68.

[112] Supra note 45. The discussion herein of this case is based in part upon Hayhoe CMDA Comment, supra note 45.

[113] Supra note 67.

audited the 1997 year of the Committee and found the same record-keeping and control failures. The Canada Revenue Agency then issued notice of its intention to revoke the registration of the Committee.

The Committee appealed its de-registration to the Court of Appeal on the basis that the Canada Revenue Agency should not have considered the terms of the agency agreement but should instead have considered whether or not the relationship between the Committee and the Foundation met the legal test for agency at common law so that activities of the Foundation were, at law, activities of the Committee. The Court decided that, on the facts of the case, there was a violation of the requirement of the Act that a charitable organization carry on its own activities. Because the Committee could not show that it had controlled or directed the activities of its agent, the activities were not carried out on its behalf.[114] Furthermore, the Committee was missing certain of the reports which it ought to have received from the Foundation and therefore could not meet the record-keeping requirements of the Act.

(b) Magen David Adom Case

Canadian Magen David Adom for Israel ("Canadian Magen David Adom") provided ambulances and other medical equipment to an affiliate in Israel ("Magen David Adom"). For a number of years (and through a number of Revenue Canada audits) Revenue Canada applied its "charitable goods policy" to permit Canadian Magen David Adom to transfer ambulances and medical supplies to Magen David Adom without the agency or joint venture agreements referred to above.

Eventually Canadian Magen David Adom was audited on two occasions by Revenue Canada at a time when Revenue Canada was no longer willing to apply the charitable goods policy to Canadian Magen David Adom. Canadian Magen David Adom's registration was revoked on the grounds of the absence of an agency or similar agreement and because its affiliate operated in the Golan Heights, the West Bank, East Jerusalem and the Gaza Strip (the "Occupied Territories") in violation of Canadian public policy. In the course of audit follow-up, Revenue Canada had obtained a list of all sites where Canadian supplied ambulances were used at the time – the list included one ambulance which had been transferred by the Israeli affiliate to the Israeli Defence Force as well as some ambulances used in the Occupied Territories.

As discussed above, the Federal Court of Appeal declined to apply a charitable goods policy and upheld the revocation. In the broader context, the *Canadian Magen David Adom* decision is instructive on several fronts. Canadian Magen David Adom is a very high profile charity. If the Canada Revenue Agency was willing to revoke its registration, no registered charity should view itself as above the law or beyond the Canada Revenue Agency's reach. The case (like the *Tel Aviv* case) also confirms the importance of dealing with issues raised in previous audits.

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[114] As discussed above, the Court's conclusion on agency is odd. Once a charity establishes that there is an agency relationship with a foreign charity, as a matter of the common law of agency the activities of the agent are activities that the Canadian charity carries on itself. If a requirement for direction and control by the Canadian charity is a good thing, it should be required by the Act, not simply adopted from the non-authoritative Canada Revenue Agency guide.

(c) Intermediate Sanctions

As a result of the 2004 Federal Budget, intermediate sanctions are about to become reality in Canada.[115] These intermediate sanctions, which had been proposed by the Joint Regulatory Table of the Voluntary Sector Initiative of the Federal Government[116], will change the compliance landscape for charities. Where the only penalty available to the Canada Revenue Agency for tax rule violations is revocation of registration which is akin to capital punishment, compliance actions may not always be an option for Canada Revenue Agency. This was demoralising for Canada Revenue Agency Charities Directorate and created uncertainty for charities. The budget gives the Canada Revenue Agency a wide range of new compliance tools. Although the details are not yet clear, these will include the ability to tax charities in some circumstances and the ability to suspend a charity's ability to issue official donation receipts or receive grants from other registered charities. The revocation power will also continue.

In the present context, charities should be particularly concerned with the proposed new intermediate sanction applicable to a charity which makes a gift other than to a qualified donee or in the course of its own charitable activities. The budget proposes to apply a tax of 105% of any amount given in violation of this rule (increasing to 110% for a subsequent offence). In the context of a registered charity which operates exclusively abroad through agency agreements, the potential consequences of a finding that its agency agreements were shams designed to hide gifts to foreign charities would be the application of this tax (which could be a more severe financial penalty than the previous (and continuing) deregistration tax in that it would exceed the year's charitable expenses which might well exceed the organization's assets).

XV. Conclusion

I have outlined the complex legal rules applicable to Canadian registered charities which fund foreign activities. Given that the Canada Revenue Agency takes this issue seriously, charities and their advisors should do the same. However, it is also important that charities which address the issue do so in ways which are minimally intrusive into how they would choose to operate without these rules. While complying with the tax law on foreign activities may not be a matter of choice, the method chosen for compliance is a choice.

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[115] Robert Hayhoe, "Canada Federal Budget Introduces Intermediate Sanctions "(Forthcoming 2004) 44:2 *Exempt Organization Tax Review.*

[116] Voluntary Sector Initiative (Canada) – Joint Regulatory Table, *Strengthening Canada's Charitable Sector: Regulatory Reform: Final Report* (Ottawa: Voluntary Sector Initiative, 2003) <http://www.vsi-isbc.ca/eng/regulations/reports.cfm>.