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## CHARITIES AND NOT-FOR-PROFIT NEWSLETTER

May 2009

*The Charities and Not-for-Profit Newsletter is published monthly by Miller Thomson LLP's Charities and Not-for-Profit Group as a service to our clients and the broader voluntary sector. We encourage you to forward the e-mail delivering this newsletter to anyone (internal or external to your organization) who might be interested.*

*Complimentary e-mail subscriptions are available by contacting [charitieseditor@millerthomson.com](mailto:charitieseditor@millerthomson.com).*

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### TREATMENT OF ENDURING PROPERTY FOR THE PURPOSES OF THE DISBURSEMENT QUOTA

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On April 22, 2009, the Canada Revenue Agency released a set of questions and answers concerning the treatment of enduring property for purposes of the disbursement quota. These questions and answers can be viewed online at <http://www.cra-arc.gc.ca/tx/chrts/plcy/csp/csp-e10-fqs-eng.html>. The questions and answers deal with numerous issues concerning endowment fund agreements and the definition of enduring property in the *Income Tax Act*. Many of these issues are particularly relevant given the current state of the Canadian economy.

It should be noted at the outset that not all types of enduring property are the same or subject to the same restrictions. Bequests, life insurance proceeds, direct receipts from an RRSP or RRIF on the death of the annuitant are all considered as enduring property, but there is nothing in the *Income Tax Act* that restricts how these funds can be used by the charity or whether the capital or income can be spent. These issues would be determined by looking at the specific terms of the gift made and are not determined by the rules in the *Income Tax Act*. It is important that charities understand that unless the gift agreement contains restrictive language, enduring property, other than ten year gifts, are not subject to the encroachment restrictions noted.

The answers published by the CRA discuss certain restrictions on encroachment which in CRA's view applies to *inter vivos* (during lifetime) gifts of enduring property (i.e., ten-year gifts).

The first question deals with how fund agreements define income. In particular, some fund agreements do not distinguish earnings on endowment portfolios among interest, dividends, and realized and unrealized capital gains. The question states that these items are all considered current earnings and the capital refers to the dollar value of the original gift to the endowment fund. The CRA states that such gifts may not qualify as enduring property. The CRA refers to paragraph (c) of the definition of enduring property in subsection 149.1(1) of the *Income Tax Act* and the fact that the gift received by the registered charity must be subject to a trust or direction to the effect that the property given or property substituted for the gift is to be held by the charity or by another registered charity for at least ten years. This is commonly referred to as a ten-year gift.

The CRA's view is that realized and unrealized capital gains relating to the original property gifted to the charity or to property substituted for the gift, form part of the gift that is subject to this ten-year holding period. Therefore, where fund agreements allow the charity to expend these capital gains prior to the end of the ten-year period, the gift may not qualify as enduring property under paragraph (c) unless such expenditures do not exceed the permissible encroachment amount. However, it is arguable that it may be possible, with careful drafting of an endowment agreement, to allow access to increases in the value of a gift, whether realized or unrealized, such that only the original value of the gift is

subject to this holding period. Given that this type of gift is essentially a trust, we think it is arguable that the trust consists of exactly the amount of the original gift. This would allow the charity to access increases in value and to expend those increases in value regardless of the encroachment limit applicable at any given time.

The second question posed of the CRA concerns encroachment on the capital of a ten-year gift to meet the disbursement quota where the terms of the gift permit encroachment. A charity is permitted to encroach on the capital of a ten-year gift within the minimum ten-year holding period to the extent of the amount determined for a taxation year by B.1 in the formula of its disbursement quota, i.e., the 3.5% disbursement quota requirement. There is nothing in the *Income Tax Act* which states a charity can only encroach where it cannot meet its disbursement quota. The response did not address this point.

The third question addresses the issue of a charity that has not tracked its capital gains pool and whether this inhibits its ability to encroach on the capital of an enduring property gift. A failure to track one's capital gains pool does not inhibit a charity's ability to encroach on capital as the rules permit encroachment on ten-year gifts up to the 3.5% disbursement quota requirement regardless of the capital gains pool balance. However, where a charity has not kept track of its capital gains pool or where the 3.5% disbursement quota requirement amount exceeds the balance of a charity's capital gains pool, the charity will be limited in its ability to reduce its disbursement quota requirement. Tracking the capital gains pool allows a charity to reduce its obligation under element A.1 of the disbursement quota (i.e., enduring property spent or transferred to a qualified donee in a taxation year). If the charity does not track its capital gains pool, it will be unable to determine the amount of the reduction to which it is entitled.

Question four suggests charities should track every ten-year gift they receive separately. For a ten-year gift to meet the definition of enduring property and therefore be excluded from element A of the definition of disbursement quota (i.e., the total eligible amount of tax receipted gifts), each ten-year gift must be subject to a trust or direction that it be held for a minimum of ten years. This minimum holding period applies to each such gift received by a charity.

Question five confirms that to the extent a charity has a disbursement quota excess, it is not precluded from encroaching on the capital of its ten-year gifts, provided that it is otherwise permitted to do so by the terms of the gift. We should note that it is essential that the terms of the gift agreement provide this right; otherwise encroachment may not be permissible. Where encroachment is not permitted by the terms of a gift, a subsequent encroachment may taint the gift and it may no longer qualify as enduring property.

Question six deals with fund agreements that allow for encroachment on capital to cover administration fees and investment management fees. The CRA has stated in its response that this may be a concern and that such gifts may not qualify as ten-year gifts. Where the fund agreement allows the charity to encroach on capital to cover administration and investment management fees, provided that such fees will not exceed the permitted encroachment amount, these gifts may qualify as enduring property. However, if the administration and investment management fees exceed this amount, the CRA states that gifts may not qualify as ten-year gifts. We query the correctness to the CRA's conclusion on this issue.

Question seven seeks to clarify whether encroachment amounts should be recognized on line 5710 of a charity's T3010 Information Return as amounts of enduring property spent in a taxation year and whether these amounts will create an 80% disbursement quota requirement in the following year. The CRA clarifies that enduring property expended in a taxation year will impact the charity's disbursement quota requirement in the taxation year in which the property is expended. Enduring property spent in the taxation year should be reported on line 5710 of the T3010 return. This will create an 80% disbursement quota requirement under element A.1 of the definition of disbursement quota. Thus, where a charity encroaches on the capital of a gift of enduring property, this amount should not be reported on line 5710. The CRA also notes that enduring property transferred to a qualified donee in a taxation year should be reported on line 5060 of the T3010 Return and that such a transfer will result in a 100% disbursement quota requirement. The analysis in this answer should apply to all types of enduring property.

Question eight deals with a charity's inability to meet its disbursement quota in 2009 because of the current financial crisis. Where a charity has failed to meet its disbursement quota due to unforeseen circumstances that are beyond its control, the charity may apply for relief under subsection 149.1(5) of the *Income Tax Act*.

This relief will be granted only under extraordinary circumstances. The CRA directs readers to its policy CPC-029 for further information. This policy was released on March 20, 2009. A charity wishing to apply for such relief can do so on Form T2094. The CRA reminds charities that regardless of its disbursement quota status, the *Income Tax Act* requires that it file an annual information return in form T3010 within six months from the end of the charity's taxation year. Please note that the CRA has recently released its new form T3010B, which must be used by all charities for fiscal years ending on or after January 1, 2009. For fiscal years ending after March 22, 2004 and up to and including December 31, 2008, charities must use form T3010A.

The final question deals with the treatment of an encroachment on a ten-year gift. Where the terms of an agreement permit the charity to expend a portion of the property gifted in excess of the permitted encroachment amount, the ten-year gift may not qualify as enduring property and 80% of the gift may be required to be included in component A of the formula for the charity's disbursement quota in the taxation year subsequent to the year in which the gift was made. Where a portion of a ten year gift that qualifies as enduring property is expended, generally 80% of the amount spent and 100% of the amount transferred to qualified donees is required to be reflected in A.1 of the formula for the charity's disbursement quota in the taxation year that the amount was expended or transferred. These rules would apply to a permitted encroachment on ten-year gift property.

In these difficult financial times, we have received many questions from our clients on a whole host of issues relating to endowed funds and the treatment of enduring property in those agreements. Charities faced with the issues outlined above, or others, are encouraged to contact us for assistance in this area as uncertainty continues to exist surrounding the definition of enduring property under the *Income Tax Act*.

## **CRA'S GUIDANCE ON THE PROTECTION OF HUMAN RIGHTS**

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The Canada Revenue Agency recently released a proposed guidance on the protection of human rights and charitable registration. This guidance emphasizes the importance of human rights with CRA's public acknowledgment that protection of human rights is a charitable purpose in Canada.

CRA will recognize organizations that seek to encourage, support and uphold human rights as charitable to the extent that these rights have been secured by domestic or international law. In the past some organizations were denied registration because the protection of human rights was seen as a political activity. The CRA's guidance explains that many of these activities are no longer political given that Canadian and international law has now established a legal regime that supports human rights.

The guidance states that advocating for new legal rights or opposing or advocating changes to current laws at the domestic or international level remains a political activity. Registered charities can engage in this type of political activity as long as the activity is connected and subordinate to the charitable purpose and consumes no more than 10% of the charity's resources (or up to 20% for smaller charities).

CRA states that what is political in one country may not be in another country. The guidance helpfully suggests that the more widespread a charity's human rights operations are internationally, the less likely limited advocacy activities in one country will be found to have a political purpose. The guidance also notes that while charities cannot carry out activities to abolish laws such as the death penalty (beyond the political limit), a charity can work within the limits of the law to ensure that such rules are not applied in individual cases.

The guidance provides several examples of acceptable activities, including:

- providing housing, medical services, basic necessities, and psychological counselling for victims of human rights abuses,
- establishing legal clinics to provide legal protection against human rights abuses,
- carrying out workshops and research on human rights,

- providing faith-based preaching and workshops on human rights,
- promoting awareness and respect for the protection of human rights,
- investigating violations of human rights laws,
- creating and disseminating reports on the progress of countries on the enforcement of human rights legislation,
- providing training to government and judiciary regarding the laws and treaties on human rights, and
- providing well-reasoned commentary and recommendations to signatory governments on the implementation of treaties.

The guidance is certainly a helpful start. It could be improved by de-emphasizing the focus on an existing legal regime. Some of the activities that CRA acknowledges as charitable in the guidance do not require an existing legal regime such as education as well as mental and physical support to victims of human rights violations as defined under international treaties, even if the victim's country is not a signatory. It would be useful if the policy acknowledged that the protection of human rights does not require protecting a legal regime.

It would also be useful if the guidance directly recognized that promotion of human rights can include public awareness campaigns about a charity's work or an issue related to that work. Again, this type of activity does not require an existing set of laws in the country and a public awareness campaign is not political according to CRA's policy on political activities, if it does not have a call to action.

A final concern is that the policy implies that a charity that has advancement of religion as its purpose will have to add a human rights activity to the organization's charitable purposes in order to protect human rights. CRA should clarify that such changes are not necessary to the extent that the protection of human rights is a tenet of the religious group's beliefs.

CRA is inviting comments on the proposed policy until July 31, 2009. Hopefully, the final guidance will provide further clarification and support to charities that protect some of the world's most vulnerable people.

## **RECORD RETENTION POLICIES**

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Non-profit organizations often rent their premises out to non-related groups to run programs involving children. The organization's own members may not be present during such programs. Although the tenant group may have confirmed that it has liability insurance, there is always the possibility that a child involved in the program, or his parents, may bring a claim against the landlord for damages suffered while the child was a participant in the tenant program. To protect against such claims, the landlord should retain all documentation proving that the tenant rented the space for as long as there is the possibility that such a claim may be brought.

In a hypothetical scenario, an employee of the tenant group running the program engages in inappropriate behaviour with the children, and the children, once grown, seek to bring a claim against the landlord.

The landlord should retain documentation that its premises were rented so as to defend against any claims based on vicarious liability, agency, or employment relationships relating to a potential sexual assault by an employee of the tenant at the rented premises. In other words, if a child is assaulted by a tenant's employee while on the landlord's property, the child may bring an action against the landlord for liability as owner of the property, vicarious liability for the actions of the employee, and the child may even claim that the employee was an agent or employee of the landlord. Having documentation regarding the rental arrangement may provide a defence against those claims. This is particularly so when the claim is brought many years after the alleged incident and it may be difficult to remember whether it was the non-profit organization or the tenant that ran the particular program.

How long should these documents be retained? Since the potential claim is assumed to be based on a sexual assault, the limitation period can be lengthy. In Ontario, currently basic the limitation period is 2 years

from the date when the claim was discovered. A claim is discovered at the earlier of when the assault took place, and when the child determines that he or she suffered damages, who assaulted him or her, and that a lawsuit is the proper action to take. The limitation period for sexual assaults prior to January 1, 2004 is 4 years. However, there are special transition rules.

The possible limitation periods that could apply to a claim based on a sexual assault are as follows:

- Basic limitation period: 2 years from when the claim is discovered.
- Ultimate limitation period: 15 years after the claim is discovered.
- There is no limitation period if the assault was committed by a person in a position of trust, authority or a fiduciary relationship.
  - It is possible that a person in a leadership position in a program for children is in a position of trust, authority or a fiduciary relationship, particularly if he or she has the ability to exercise some discretion or power so as to affect the child's interests, and if the child is particularly vulnerable to or at the mercy of the leader.
- For sexual assaults, the limitation period does not run during any time in which the plaintiff was incapable of commencing litigation because of his or her mental, physical or psychological condition. It is presumed that the plaintiff was incapable of bringing the action until he or she did actually bring it, unless the evidence proves otherwise.
- For minors, the limitation period is suspended until they reach the age of majority (18 years) or have a litigation guardian appointed.

Based on these possible limitation periods, the limitation period in the hypothetical scenario could be 15 years, until the child reaches the age of majority, or until the child is capable of bringing an action, or perhaps there may be no limitation period. The most prudent course of action for a non-profit organization in this position would be to retain records indefinitely, or for at least 25 years, so as to allow the 15 year ultimate limitation period to pass after an 8-year old child reaches the age of majority. It must be kept in mind that if a tenant employer is found to be in a position of trust and authority with respect to the child, there will be no limitation period. In any particular case, the determination of whether the limitation period has expired will be based on the facts in that situation.

Miller Thomson's lawyers can assist in developing appropriate record retention policies, and in advising generally on ways in which organizations may reduce potential liability.

## **CRA POLICIES/GUIDELINES RESEARCH, SPORTS, VOLUNTEER EXPENSES, AND REGISTRATION**

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In the June 2008 edition of the Miller Thomson LLP *Charities and Not-for-Profit Newsletter*, we reported on the CRA's draft sport policy. The CRA still maintains that promotion of sport in itself is not a recognizable charitable purpose. Unless sports are an activity that furthers an organization's charitable purposes, they may only be used in a purely incidental way.

The types of factors relevant in determining whether a charitable purpose is furthered by sports activities are: the effectiveness of particular sports in achieving a charitable purpose, public accessibility to the sports activities, and participation levels.

To view CRA's "Sports and Charitable Purposes", please refer to the CRA's website at <http://www.cra-arc.gc.ca/tx/chrts/plcy/cps/cps-027-eng.html>.

## Research as a Charitable Activity

In the February 2008 edition of the Miller Thomson LLP *Charities and Not-for-Profit Newsletter*, we reported on the CRA's policy on research as a charitable activity. This policy was revised on April 30, 2009. The updated policy continues to recognize research as a charitable purpose under the heads of advancement of education and other purposes beneficial to the community.

Generally speaking, the criteria governing charitable research specified in our February 2008 *Newsletter* still hold valid under the revised policy. The CRA stated that dissemination of charitable research does not have to be made available to the public free of charge. Any costs charged should be based on cost-recovery associated with dissemination of the research findings. The costs should still allow most people to have access to the research.

The revised policy expressly states that depending on an organization's charitable purpose and the relevant facts, failure to fulfill all five requirements will not automatically lead to the conclusion that the organization's research is not charitable, or recognizable as such by the CRA.

The guidance "Research as a Charitable Activity" is available on CRA's website at <http://www.cra-arc.gc.ca/tx/chrts/plcy/cps/rsrch-eng.html>.

## Expenses Incurred by Volunteers

On April 28, 2009, the CRA released a revised policy commentary on expenses incurred by volunteers on behalf of registered charities. This commentary is intended to clarify the Charities Directorate's views on whether these expenses can constitute donations for the purpose of charitable receipts.

The CRA proposes that registered charities should have a policy with respect to reimbursing volunteers who incur expenses on behalf of charities. Generally, these policies should dictate both the type of expenses that are reimbursable and the proper procedure for processing reimbursement.

Instead of issuing charitable donation receipts directly for expenses incurred by volunteers, charities are encouraged to proceed under an exchange of cheques so that proper financial records are created. Therefore, where a volunteer incurs an expense on behalf of a charity, the charity should issue a cheque to the volunteer reimbursing all proper expenses. Thereafter, the volunteer may choose to write a cheque back to the charity for an equal or lesser value as a donation.

Where a charity seeks to issue an official donation receipt to a volunteer in lieu of reimbursing that volunteer's expenses, the charity should have written authorization from the volunteer. The CRA provides the following as an example of acceptable wording for such authorization:

I (name of volunteer) direct that the funds to which I am entitled by way of reimbursement for (explanation of expense incurred), and would otherwise be forwarded to me by cash or cheque, be transferred to (name of charity) as my gift.

Where charitable receipts are issued for income tax purposes in lieu of reimbursement, the amount of the gift should be reported as both revenue and an expenditure on the Registered Charity Information Return (Form T3010).

To view CRA's "Expenses Incurred by Volunteers", please refer to the CRA's website at <http://www.cra-arc.gc.ca/tx/chrts/plcy/cpc/cpc-012-eng.html>.

## Applying for Registration:

The CRA has recently added new topics and sub-topics to its online information repository entitled "Applying for Registration" as a charity. These topics include:

- How to apply
- What is charitable?
- Describing your activities
- The application review process
- What is a governing document?
- Incorporation documents

- Constitutions
- Trusts
- Make an informed decision
- Advantages of registration
- Obligations of registration
- Consequences of terminating registration
- Types of registered charities (designations)
- Forms and publications
- Factors that will prevent an organization from being registered
- Other organizations that can be registered
- Questions and answers

To view the full content of these additions, please refer to the CRA's website at <http://www.cra-arc.gc.ca/tx/chrts/pplyng/menu-eng.html>.

## WHAT'S HAPPENING AROUND MILLER THOMSON LLP

**Arthur Drache** wrote "Committee Hearings on Non-Profit Corporation Bill", "CRA Issues Advice on Disbursement Quota Relief", "OECD Report on Money Laundering and Charities", "Obama Tax Policy Defence", "Indicator or Aberration" and "New Journal Available On-Line" in the May 2009 issue of *Canadian Not-For-Profit News*.

**Arthur Drache** led a half day workshop in Calgary for the local chapter of the Association of Fundraising Professionals which focused on donation issues arising in difficult economic times.

**Sandra Enticknap** will be presenting at Leave a Legacy, a program of the Canadian Association of Gift Planners of Greater Vancouver on "What Estate Planning Can Offer You" on May 28, 2009

**Richard Fontaine** became a member of the Committee of Gift Planning of the Business School (Hautes Études Commerciales or HEC Montréal ) of the University of Montréal.

**Susan Manwaring** spoke at the Canadian Bar Association and Ontario Bar Association's National Charity Law Symposium on May 7, 2009 at the Inter Continental Toronto Centre Hotel. Susan presented on the new CRA Fundraising Guidance.

**Susan Manwaring** presented at a workshop on "Charities with Oversea Operations together with the Canadian Council of International Cooperation on April 27 and 28 in Victoria and Edmonton.

**Susan Manwaring** and **Hugh Kelly** wrote "Enforcing Restrictions on Gifts" in the May 2009 issue of *Canadian Not-For-Profit News*.

**Susan Manwaring, Hugh Kelly** and **Amanda Stacey** wrote "Non-share Capital Corporations: Charities and Not-for-Profit" in the newly published *Business Laws of Canada* released in 2009 by Thomson Reuters/West.

**Brenda Taylor** presented at the Annual Conference for the Institute of Law Clerks of Ontario on May 21 on the following topics: status of federal and Ontario reform, continuation requirements, incorporation, organization, charitable registration (Ontario and federal), corporate maintenance/annual proceedings/Government filings, and ongoing CRA/PGT/MGS reporting requirements.

**Rachel Blumenfeld** presented on "New Developments in Philanthropy" at the May 22nd workshop on "Law and Tax for the Charitable Sector" presented by the York Region Community Foundation. Miller Thomson was a sponsor of the workshop.

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