Occasional Paper

Reflections from an Uncomfortable Fence: Recent Discussions on the Regulation of Canadian Charities Operating Abroad

Carl Juneau, LL.L., B.A.

The Pemsel Case
FOUNDATION

ISBN: 978-1-7753500-3-3

"The law of charity is a moving subject"
– Lord Wilberforce

About Us

Named after the 1891 House of Lords decision, *Commissioners for Special Purposes of the Income Tax v. Pemsel*, [1891] A.C. 531, which established the four principal common law heads of charity used in Canada and elsewhere, The Pemsel Case Foundation is mandated to undertake research, education and litigation interventions to help clarify and develop the law related to Canadian charities. The Pemsel Case Foundation is incorporated under the Alberta *Societies Act* and is a registered charity.

The Pemsel Case
FOUNDATION

Suite 1150, 10060 Jasper Avenue,
Edmonton, Alberta, T5J 3R8

www.pemselfoundation.org

Table of Contents

Reflections from an Uncomfortable Fence: Recent Discusstions on the Regulation of Canadian Charities Operating Abroad

Reflections from an Uncomfortable Fence: Recent Discussions on the Regulation of Canadian Charities Operating Abroad*

1. Introduction

The Canadian *Income Tax Act* requires Canadian registered charities to function in one of two ways: they can fund "qualified donees," or they can use their funds on their "own activities."[1]

"Qualified donees" are mostly other Canadian registered charities. Consequently, this requires a charity wanting to carry out operations outside of Canada to be directly involved, except in limited specified cases. The charity needs to meet the "own activities" test and comply with a Canada Revenue Agency ("CRA") policy on "direction and control" to demonstrate these are "its own activities."[2] This approach is significantly at odds with current international practice. Simply transferring funds to a foreign recipient is not enough.[3]

On the one hand, the CRA administrative policy mentioned above requires, when working through a foreign intermediary, that a Canadian charity:

- create a written agreement with the intermediary, and implement its terms;
- communicate a clear, complete, and detailed description of the activity to the intermediary;
- monitor and supervise the activity;
- provide clear, complete, and detailed instructions to the intermediary on an ongoing basis;
- require the intermediary to keep the charity's funds separate from its own, and to keep different books and records; and
- make periodic transfers of resources, based on demonstrated performance.[4]

CRA's administrative policy CG-002[5] gives a detailed explanation. Readers can review CG-002 to assess the complexity of the requirements.

---

* The author, Carl Juneau, is a former federal government official, who served in an executive role in the Canada Revenue Agency Charities Directorate and as a policy advisor in the Department of Finance. He has been following developments in Canadian charity law for more than four decades.

[1] *Income Tax Act,* definition of a "charitable organization" and "charitable foundation", s.149.1(1), and ss. 149.1(2)(c), 149.1(3)(b.1), and 149.1(4)(b.1).The test commonly referred to as the "own activities" test arises out of the language of the Act that requires charities to operate either by funding "qualified donees", or through "charitable activities carried on by the organization itself".

[2] Canada Revenue Agency, Charities Directorate, Guidance CG-002, "Canadian registered charities carrying out activities outside Canada" https://www.canada.ca/en/revenue-agency/services/charities-giving/charities/policies-guidance/guidance-002-canadian-registered-charities-carrying-activities-outside-canada.html .

[3] The problem also occurs in a domestic context, for instance if a registered charity wants to fund a project in a First Nations community. See Etienne Plamondon Émond, « Plaidoyer pour une modernisation des règles », *La Presse,* November 13, 2019.

[4] Guidance CG-002. *op. cit.*

[5] *Ibid.*

This approach stands in stark contrast, for instance, to the *Code of Ethics and Operational Standard* of The Canadian Council for International Cooperation ("CCIC"), the leading network of Canadian charities and civil society organizations operating internationally:

- Partnerships should be vehicles for long-term accompaniment that supports the right of peoples to determine and carry out activities that further their own development options through their civil society organizations;
- Partnerships embody equity. Acknowledging that inequalities often exist as a result of power dynamics, especially in funding relationships, partners should strive for equitable partnerships;
- Partners should respect one another's autonomy and constraints and strive to foster a climate of mutual trust in all their partnership activities.[6]

The "direction and control" requirements conflict with Canadian international development policy, which expects non-governmental organizations "to follow partnership principles of local ownership, participation and inclusive decision-making." They compromise practical humanitarian assistance by raising the costs of assistance, posing all kinds of obstacles and formalities in international cooperation, with little evidence these requirements prevent harm. The limitations are outdated, at odds with practices in other jurisdictions and contemporary values of inclusion and local decision-making. And they foster uncertainty because of their discretionary nature.[7]

In light of the recent report of the Senate Special Committee on the Charitable Sector[8] and various tax policy considerations, the present paper summarizes and responds to two recent articles on the topic:

Andrew Valentine

"Foreign Activities by Canadian Registered Charities: Challenges and Options for Reform"

Terrance Carter and Theresa Man

"Direction and Control – Current Regime and Alternatives"

Both are available on The Pemsel Case Foundation website.[9]

The current paper hopes to provide a cursory view of the issues under discussion, identify potential stumbling blocks, and manage expectations.

2. The Recommendation in the Senate Report

The Special Senate Committee on the Charitable Sector released its Report in June 2019. Among many other recommendations touching the regulation of Canadian charities through the *Income*

---

[6] Quoted, in Malcolm Burrows, "New Series: Canadian Charities Working Internationally" in *The Philanthropist,* March 22, 2015.

[7] The Senate Special Committee on the Charitable Sector, *Catalyst for Change: A Roadmap to a Stronger Charitable Sector*, June 2019, at p. 91-96. https://sencanada.ca/content/sen/committee/421/CSSB/Reports/CSSB_Report_Final_e.pdf .

[8] *Ibid.*

[9] For Carter and Man, see: https://www.pemselfoundation.org/wp-content/uploads/2020/04/Direction-and-Control-Current-Regime-and-Alternatives.pdf; for Valentine, see: https://www.pemselfoundation.org/wp-content/uploads/2020/06/Foreign-activities-by-canadian-registered-charities-challenges-and-options-for-reform-_circulated-March-6-2020.pdf .

Tax Act, the Committee recommended CRA move from a "direction and control" test, to a more realistic "expenditure responsibility" test.

> Recommendation 30
>
> That the Government of Canada direct the Canada Revenue Agency to revise Guidance CG-002 "Canadian registered charities carrying out activities outside Canada." The revised guidance should demonstrate a shift in focus from "direction and control" to careful monitoring through the implementation of an "expenditure responsibility test."[10]

The concept of "expenditure responsibility" will be discussed further below. In a very summary way, it does not require a charity to supervise operations in the field but instead expects a charity to ascertain that its funds will indeed be used for charitable purposes by the intended recipient.

3. Summary of Current Legislative Provisions

The tax policy considerations underpinning the federal charity regime are embodied in tax and related legislation but are usually not explicitly stated. Because of constitutional, administrative or other concerns, the connection between policy intent and particular legislative measures is often not easily discerned. Any replacement for the current "direction and control rules" would need to address all the relevant policy considerations.

(a) The *Income Tax Act*

The existing structure of the *Income Tax Act* ("ITA") regulating the use of charitable funds presumes a closed system. Once donations and other tax-assisted funds enter the system, the rules prevent the resources from leaking out into unacceptable ventures. Supposedly, the use of the closed system ensures charities use funds impressed with a charitable purpose for that purpose, not diverted to other, unacceptable purposes.

This closed system has existed at least since the 1960s, although the ITA had some restrictions loosened following the 1976 overhaul of the provisions regulating charities.

After the 1976 overhaul, the ITA required charities to spend a specified proportion of funds either on their "own activities" or on gifts to "qualified donees." At the time, the view of the Department of National Revenue[11] was that any excess covered administrative and fundraising costs. But arguably, the excess could also have been used to fund other – even foreign – charities. Indeed, some charitable foundations did engage in overseas financing of organizations. Several ITA amendments in the early 2000s corrected this legislative omission.

As early as 1966, the Royal Commission on Taxation recommended that charities be allowed to carry on their work both in and outside Canada.[12]

---

[10] *Ibid*, p. 96. See also Report recommendations 31 and 32.

[11] Now the Canada Revenue Agency.

[12] Tellingly, at p. 132, vol. 4, the Commission's report stated:

As well, absent the ITA constraints, there is a strong argument that Canadian charities can legitimately fund foreign charities without any restriction. In *Lewis v. Doerle,*[13] concerning a trust "to promote, aid, and protect citizens of the United States of African descent, the Court, citing with approval *Curtis v. Hutton,*[14] ruled that "it made no difference where the charitable trust was to be executed."

More recently, *Re Levy Estate*[15] dealt with a trust benefitting several charities in a foreign country. The Court held that:

> A trust which falls under the fourth head of charity, "other purposes beneficial to the community", if charitable according to law, does not lose its charitable character merely because the charitable activities are to be carried on in a foreign country for the benefit of that country and where there is no direct benefit to Canada.

In the United Kingdom, *Commissioners of Inland Revenue v. The Helen Slater Charitable Trust Ltd*.[16] dealt with the case of an English charitable trust funding other charities and addressed the matter under the UK *Income and Corporation Taxes Act* and its *Finance Act. The Slater case* ruled that funds transferred to another charity had indeed been "applied" to the charitable purposes of the trust. In that case, Oliver, L.J. stated at 56:

> The Crown's proposition is a startling one; it involves this, that the trustees of a grant-making charity, although they may discharge themselves as a matter of law by making a grant to another properly constituted charity, are obliged if they wish to claim exemption under the subsections to enquire into the application of the funds given and to demonstrate to the Crown how those funds have been dealt with by other trustees over whom they have no control and for whose actions they are not answerable. Anything more inconvenient would be difficult to imagine, and I find myself quite unable to accept that the legislature, in enacting these sections, can possibly have intended such a result. For my part, I entertain no doubt whatever that, as a general proposition, funds which are donated by charity A, pursuant to its trust deed or constitution to charity B, are funds which are 'applied' by charity A for charitable purposes.[17]

> The Department appears to have attempted to administer the provisions of the Act dealing with charitable organizations somewhat restrictively.(…) Where possible, the Department attempts to bring charities under 62(1)(f) rather than 62(1)(e) because of the restrictions contained in (f), and *also attempts to insist in many cases that charitable activity must be confined to Canada.* (emphasis added)

However, further, at pp. 134-135, vol 4, the Report states:

> It should be made clear that charitable organizations can carry on their work inside or outside Canada. While the 1966 amendments (recognizing certain foreign organizations as eligible for tax assisted donations) provide partial relief in this regard, we would prefer that the definition be expanded further.

Report of the Royal Commission on Taxation, 1966, Ottawa, Queen's Printer, Volume 4.

[13] (1898) 25 O.A.R. 209.

[14] (1808) 14 Ves. 537.

[15] (1989) 68 O.R. (2D) 385.

[16] (1980-1984) 55 TC 230.

[17] The case has been followed in a number of other Commonwealth jurisdictions. Note, in addition, the oft-quoted case *Pemsel v. Inland Revenue Commissioners*, which established the method for determining the legal meaning of charity, also interestingly dealt with charitable cross border purposes and activities. The judges in Pemsel's case found nothing amiss with a trust to advance "the missionary establishments among heathen nations" in the context of a UK-wide taxing statute. Lack of

(b) The *Charities Registration (Security Information) Act*

The *Charities Registration (Security Information) Act*[18] is intended to preserve the integrity of Canada's registered charities system by preventing organizations that support terrorist activities from obtaining or continuing to have registered charity status under the *Income Tax Act.*

Generally, intelligence and security information that would inform decision-makers about organizations operating in support of terrorism is classified for national security purposes. Because all information on which the CRA currently bases its decision to deny or revoke charitable status for purposes of the *Income Tax Act* is subject to full disclosure in open court, the CRA in practice prefers to avoid basing its decisions on security information. Disclosure of that information would undermine national security, third-party confidentiality and source protection. The Act allows the government to use and protect relevant classified information in its decisions to deny or revoke the registration of charities.[19]

4. Case Law on "Direction and Control"

Canadian courts have addressed several cases on "direction and control" by charities operating abroad.[20] But the decisions are generally unhelpful beyond affirming the necessary framing of the "direction and control" test. This result may be because the cases dealt with fundamental non-compliance or sham arrangements.

The *Tel Aviv* decision,[21] for instance, did recognize that a charity could operate abroad through an agency agreement, but it also acknowledged that a charity should be able to demonstrate that it is the principal in any agency relationship and not the agent of the foreign organization. When *Tel Aviv* was decided, the prevailing view was that agency agreements were a sufficient prerequisite to demonstrating the exercise of direction and control by a Canadian charity.

Still, *Tel Aviv* and related cases can be read as allowing for a much lower bar than the CRA policy expressed in GC-002 in terms of the requirements that a charity must meet. But for the GC-002 policy, the issue isn't whether a charity needs an agency agreement – it's the complexity and the rigour of the added formalities a charity has to go through to satisfy the policy.

---

direct or indirect public benefit to the local jurisdiction or the inability of the Attorney-General to supervise such charities in a foreign jurisdiction has also been repeatedly brushed aside in many cases since 1891. McGregor-Lowndes, Tarr and Silver, "The Fisc and the Frontier: Approaches to Cross-border Charity in Australia and the UK", in *The Philanthropist,* April 2015.

[18] 2001 S.C., c. 41, s. 113.

[19] Parliamentary Research Branch, Legislative Summaries, *Bill C-16, Charities Registration (Security Information) Act,* Library of Parliament, October 16, 2001. Government officials have acknowledged (p.8) that in isolation the Act does not go far enough to meet Canada's obligations under the 1999 United Nations Convention on the Suppression of the Financing of Terrorism. That Convention requires signatory states to enact domestic legislation criminalizing the collection of funds for terrorist activities.

https://lop.parl.ca/staticfiles/PublicWebsite/Home/ResearchPublications/LegislativeSummaries/PDF/37-1/c16-e.pdf .

[20] *Canadian Committee for the Tel Aviv Foundation v. R.,* 2002 F.C.A. 72; *Canadian Magen David Adom for Israel v. Canada (Minister of National Revenue),* 2002 F.C.A. 323; *Bayit Lepletot v. Canada (Minister of Natioal Revenue),* 2006 F.C.A. 128; *Public Television Association of Quebec v. Minister of National Revenue,* 2015 F.C.A. 170. The "direction and control" test has also been applied in cases involving charities operating domestically: See *Sagkeeng Memorial Arena Inc. v. Canada (National Revenue),* 2012 F.C.A. 171.

[21] 2002 F.C.A. 72.

5. Current Administrative Policy

The consensus of opinion in the charitable sector is that the policy in CG-002 is excessive and unduly constraining, and that the provisions in the *Income Tax Act* underlying the policy are outdated and not consistent with current practices in international charity.

In the court cases referenced above, the decisions may have recognized that a Canadian charity needs to exercise some control over the funds it sends abroad. This principle may be reasonable. But the issue is less about absolute control and more about the degree of control. And this is where the *Income Tax Act* gives the CRA considerable latitude in determining what is required.[22]

The ITA doesn't set out the "direction and control" requirement. Arguably, it may be a reasonable extrapolation of the "own activities" rule. But it still leaves the matter open to broad discretion. Indeed, in the context of corporate personality, there is considerable leeway in construing an activity to be the activity of the organization, since, by necessity, a body corporate can only operate through intermediaries – individuals or other entities that have legal standing.

In fairness, Guidance CG-002 states it does not have the force of law. But the wording is not flexible and the uncompromising tone it signals manifests itself downstream in audits, educational letters and revocations.[23] In the hands of the CRA, the "direction and control" test expanded into a substantial requirement that *all* activities be "…*directly under* the charity's control and *supervision*."[24]

The Carter and Mann paper shows the onerous nature of the CG-002 requirements.[25] A charity:

- must maintain a record of steps taken to direct and control the use of its resources, as part of its books and records
- must be the body that makes decisions and sets parameters on significant issues related to the activity on an ongoing basis, such as the following:
    - how the activity will be carried out
    - the activity's overall goals
    - the area or region where the activity is carried out
    - who benefits from the activity
    - what goods and services the charity's money will buy
    - when the activity will begin and end
- should be able to document its exact nature, scope, and complexity. This includes determining in advance:
    - exactly what the activity involves, its purpose, and the charitable benefit it provides
    - who benefits from the activity
    - the precise location(s) where the activity is carried on

[22] *Income Tax Act,* s. 230(2): Every [charity]… 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…

[23] A. Valentine, *op. cit.,* p. 6.

[24] CG-002, *op. cit.,* emphasis added.

[25] Terrance Carter and Theresa Man, *op. cit.,* pp. 14-18.

- a comprehensive budget for the activity, including payment schedules
- the expected start-up and completion dates for the activity, as well as other pertinent timelines
- a description of the deliverables, milestones, and performance benchmarks that are measured and reported
- the specific details concerning how the charity monitors the activity, the use of its resources, and the intermediary carrying on the activity
- the mechanisms that enable the charity to modify the nature or scope of the activity, including discontinuance of the activity if the situation requires (for example, the intermediary begins misusing funds)
- the nature, amount, sources, and destination of income that the activity generates, if any (for example, tuition fees from operating a school, or sales from goods produced by poor artisans in third-world countries
- any contributions that other organizations or bodies are expected to make to the activity.

The existence of a written agreement is not enough. A charity apparently "*must* also be able to show the CRA that the charity has *a real, ongoing, active relationship* with its intermediary.*"*[26]

These stipulations go clearly beyond the law of agency, and while logically one should assume the need to keep records that will reasonably satisfy the Minister as to the proper application of funds, the current policy constricts Canadian charities so significantly that it prevents them from operating efficiently in a foreign setting.[27]

6. Recent Proposals

Several administrative options are advanced in both the Valentine and the Carter and Man papers. Valentine offers several options in a Canadian context; on the other hand, the Carter and Man paper delves more extensively into comparative approaches in the United States and the United Kingdom to draw compromise recommendations that could be applied in Canada.

The papers suggest some of these options are attainable without changing the legislation.[28]

- Address areas of uncertainty in the existing Guidance CG-002.[29]

[26] CG-002; emphasis added. Contrary to the footnoted text in the policy, this statement taken at face value is not supported by case law.

[27] The rigor of this policy also raises issues of further research on administrative law markers of reasonableness in policy development. To what extent does CRA expertise in tax audits justify the detail of the policy in CG-002 in light of the challenges faced by Canadian charities abroad? Can CRA require absolute and slavish compliance with all the requirements set out in the policy?

[28] In addition, the CRA is not bound by past administrative policies. The Minister's only obligation is to interpret the relevant provisions of the *Income Tax Act*, and to determine how those provisions should be administered in each case. *Canadian Magen David Adom for Israel v. M.N.R,* 2002 F.C.A. 323, at paragraph 69. See also, A. Valentine, *op. cit.,* p.9. Note that the "charitable goods policy" expressed in CG-002 is a clear departure from the "direction and control" rule but is still allowed by the CRA.

[29] A. Valentine, p. 7.

- Adopt a reasonableness standard for policy enforcement to prevent excessive demands being placed on individual charities.[30]
- Harmonize monitoring requirements with government funders such as Global Affairs Canada. Monitoring by other government authorities would be deemed sufficient in terms of Canadian charities' accountability for the use of funds.[31]
- Allow greater discretion by intermediaries such as agents of the Canadian charity abroad.[32]

If discussions between the CRA and the charitable sector during the past two decades are any indication, expectations of success should be modest. This will become more apparent below.

Several other options imply legislative change:

- **Allowing "grants" to foreign organizations:** This essentially involves amending the *Income Tax Act* to distinguish between a "grant" and a "gift", it being understood that the latter is only acceptable in the context of a charity's "own activities" or in transfers to "qualified donees".[33] Grants, as distinguished, could involve the Canadian charity[34] and any other organization, foreign or domestic. They would be conceived as transfers of funds subject to a grant agreement restricting the application of the funds by the grantee, solely for one of the grantee's charitable projects consistent with the purposes of the grantor charity. The process would be subject to "grant responsibility guidelines" issued by the CRA. These would include guidance on reasonable and proportionate due diligence, the drafting of grant agreements, progress reports, budget reports and return of unused grant funds. The relationship under the grant agreement would be a contractual one, with consequences if the terms of the agreement were breached.[35]

- **Equivalency determination**:[36] This refers to preliminary steps to funding, where either the Canadian charity or the CRA would assess whether a potential foreign recipient of charitable funds was the equivalent of a Canadian charity. This would be based on the written advice of a qualified tax practitioner, supported by a duly executed affidavit containing extensive information,[37] as well as governance and financial documents.

---

[30] *Idem*, p. 8.

[31] *Ibid.* While attractive in terms of projects that are sponsored by the Canadian government, this option may not meet the "own activities" requirement and may consequently require a legislative amendment.

[32] *Ibid.*

[33] One could quibble whether assistance given directly to a charity's beneficiaries is actually "a gift", or some other form of benefaction. If a child pays tuition to attend a school run by a registered charity, is the resulting education a gift? That, however, is probably fodder for further discussion in another context. It may however point, along with a number of other factors, to the need to engage in a wholesale review of the provisions of the *Income Tax Act* as they relate to charities.

[34] One proposed variation involves restoring only the Canadian charitable foundations' ability to fund other charities, foreign or domestic, as was the case prior to the amendments brought to the Act in the past decades.

[35] Carter and Man*, op. cit*. p.53-59; Valentine, *op. cit*., p. 9. To be fair, the Carter and Man focus on a "grant" approach is part of a larger package which includes separate guidelines for charities wishing to fund organizations domestically, as well as a reform of the legislation, notably around the "own activities" test. They suggest that the grant-making approach could be complemented, by eliminating the "own activities" reference in the Act with a reference to carrying on charitable activities generally – thereby allowing charities to partner with other organizations in the pursuit of common projects (p. 57).

[36] A. Valentine, *op. cit.*, p. 10; T. Carter and T. Man, *op. cit.,* 39, 48.

[37] If the comparable United States approach was followed.

Essentially the documentation would be intended to allow the CRA to determine whether the recipient would be registered as a charity if it were to apply.

- **List certain foreign organizations as "qualified donees":**
  This approach would involve recognizing certain foreign organizations as equivalent to a Canadian charity for the purpose of only receiving funds from registered Canadian charities. In that sense, it is not unlike the "equivalency determination" approach mentioned above. It could apply to a foreign charity from any country, or only from countries with some effective oversight on sector organizations. This would essentially involve duplicating the approach for charitable registration domestically, but with attendant complexity, added controversy and challenges especially in countries where humanitarian aid typically takes place, along with an inability to audit and consequently prosecute. Even if it wasn't intended, a published list would also incite Canadian donors to give directly to the foreign charity and persuade a participating Canadian charity to issue a corresponding tax receipt.[38]

- **Expenditure responsibility:** By contrast with the options above, "expenditure responsibility" is not a legal transaction or a legal relationship *per se*, but a vetting process that could be implemented, likely subject to an enabling legislative amendment,[39] and with the support of suitable CRA administrative policy. It essentially involves placing any Canadian charity in front of its duty to ensure that funds it transmits to other organizations – whether foreign or domestic – will be properly applied in a manner consistent with its charitable purposes. The process could apply to all operations a Canadian charity would want to undertake through or with other parties.[40]

7. Issues

(a) Administrative Burden

The common thread in the options mentioned above is that they tend to displace the charity's burden from "operational control" to "expenditure control," and consequently are more in line with current international assistance standards. But it would be naïve to assume that these options relieve charities from a considerable administrative burden. Whatever the reform approach taken, it is likely that it will result in significant and potentially onerous administrative requirements. These outcomes need to be considered in contemplating changes.

---

[38] A. Valentine, *op. cit.,* p. 10; T. Carter and T. Man, *op. cit.*, p. 49.

[39] The Senate Report, perhaps on the basis of a Canadian Bar Association submission of 2009, seemed to conclude that abandoning a "direction and control" standard in favor of an "expenditure responsibility" approach was achievable without legislative change. Given recent amendments to s. 149.1 (2)(c), 149.1(3)(b.1) and 149.1(4)(b.1) of the *Income Tax Act*, this has become more doubtful.

[40] In the United States where this concept is currently applied, under section 4945(h) of the *Internal Revenue Code,* expenditure responsibility means that a charity "is responsible to exert all reasonable efforts and to establish adequate procedures" to (1) see that a grant is spent solely for the purpose for which it is made, (2) obtain full and complete reports from the grantee on how the funds were spent, and (3) make full and detailed reports with respect to the grants. The standard of the prudent man applies. Marcus Owens, "International Grantmaking by U.S. Foundations: The Concept of Expenditure Responsibility", in *The Philanthropist,* April 2015.

In the United States, for instance, charities wishing to fund foreign organizations in the context of "expenditure responsibility" have to undertake a pre-grant enquiry to obtain "…basic information about the proposed grantee, including its identity, its prior history and the experience of its managers, including a review of "readily available" information about the grantee's management, activities, and practices."[41] The US charity can only release the funds:

> *…pursuant to a written grant agreement that is signed by an appropriate officer, director, or trustee of the grantee organization and which clearly sets forth the purpose of the grant. The agreement should also require that the grantee organization (a) repay any unused grant funds, (b) submit annual reports to the grantor foundation that describe the uses made of the funds and the progress towards accomplishing the purposes of the grant, (c) maintain financial records and make them available to the grantor foundation at reasonable times, (d) agree not to use any of the grant funds for purposes that are not charitable.*[42]

Further, in reporting to the Internal Revenue Service, the US charity is required to include pertinent information about expenditure responsibility grants on its annual information return filed. The specific information consists of the grantee's name and address, the date and amount of the grant, the purpose of the grant, the amounts that have been expended by the grantee to date (based on the latest annual grantee report), the dates of any grantee reports, the dates and results of any efforts at verification of the information in the grantee reports, and whether the grantor foundation is aware of any diversions of grant funds for purposes not outlined in the grant agreement.[43]

If the Canadian system were to move to such an arrangement, one can expect that the tax authorities would be justly interested in the same level of administrative detail. The suggestion in the Carter and Man paper is that a proposed Canadian "granting" approach could borrow elements from the relatively demanding US model but strike a balance with the more principled but less specific approach found in the UK.[44]

In the context of a taxing statute, and in particular the discretion afforded to the Minister by s. 230(2) of the Act, I do not think this is persuasive. It is more likely that a Canadian tax administration would prefer the US approach. Notably, with regard to the registration of foreign organizations as qualified donees, given the existing and rather ponderous registration process for Canadian charities, especially those whose applications are marginal, one is entitled to worry that the complexity of a registration process for foreign organizations could be quite daunting. It is fair to expect government officials to view with suspicion information coming from countries where humanitarian actions take place but where almost by definition, conflict is rife, and corruption and maladministration are commonplace. Such cases might raise additional difficulties in security screening or in obtaining additional information, particularly from foreign governments that might take a dim view of charity operations within its jurisdiction.

---

[41] *Ibid.*

[42] *Ibid.*

[43] *Ibid.*

[44] T. Carter and T. Man, *op. cit.,* 34-35.

(b) Reasonableness

The preceding paragraphs bring us to consider a standard of reasonableness expected of policy formulation, enforcement, and compliance.[45] Even if there is less emphasis on operational control by moving to an "expenditure responsibility" approach as is the case in the United Kingdom and the United States, such a solution will not reduce overly cumbersome administration unless there is a change in the way policies are enforced.[46]

The current policy, which ostensibly, but questionably, functions as a flexible interpretation of the law, does not countenance alternative approaches that a charity might prefer because of considerations of impracticality or efficiency. Regardless of the legislative option chosen, this is likely to continue unless there is a change of culture and attitude within CRA.

The existing policy occasionally refers to reasonableness, but this somehow does not percolate into compliance monitoring. What is likely needed is some compelling direction in the legislation, as is found in the United States, where reasonable efforts by charities are connected to "prudent man" standards.[47] Such references to reasonableness in the relevant legislation will help address (but may not entirely solve)[48] a needed change in the approach by tax administrators dealing with charities. Tax auditors focus on uncovering every dollar of taxable income – not the appropriate mindset for a charity audit.

Reporting should be less onerous but require information that would allow a reasonable person to gain assurance as to the charity's due diligence. The test should be whether any expenditures by a charity are reasonably in furtherance of its registered purposes.

(c) Specificity of Approaches and the "Own Activities" Test

Except for "expenditure responsibility," the proposals outlined above, taken in isolation, tend to be relationship-specific: they deal primarily with the outright funding of a foreign organization for specific purposes. They do not address the diversity of ways Canadian charities engage in charitable relief abroad, including:

- International relief and development organizations that coordinate their worldwide charitable efforts through an international head office;
- Physical persons in a foreign country who act on behalf of a charity, but are not employees or contractors;
- Religious organizations that are subject to an international ecclesiastical hierarchy controlled outside Canada (*e.g.*, the Catholic Church, the Church of Christ Scientist);

[45] A. Valentine, *op. cit.,* p. 9, for the adoption of reasonableness standards in administrative policy.

[46] T. Carter and T. Man, *op. cit.*, p. 48.

[47] See s. 4945(h) of the *Internal Revenue Code*; and multiple references to the reasonableness criterion in Treasury Regulation s. 53.4945-5.

[48] Cf. the alleged standard of reasonableness by which the Federal Court of Appeal has judged the CRA's actions in a number of cases.

- Partnerships and joint ventures where resources are combined and where the Canadian charity does not play a sufficient role in determining the approach and expenses relating to a particular issue;
- Microenterprise initiatives;
- Charities that participate in relief efforts under the aegis of a branch of government.

The problem with defining a grant as one aspect of a charity's "own activities" is that it leaves unspecified many other transactions by a charity that aren't inherently charitable in character. It does not deal with the fact that a "related business" operated with or without paid employees, domestically or abroad, is not a "charitable activity" as CRA applies the term. It does not deal with the notion that a fund-raising activity is not, according to the CRA, inherently charitable. [49] It does not deal with the apparent conflict between the definition of a charitable organization as one that devotes its resources exclusively to charitable activities, yet still has administrative and fundraising expenses.

The concern is that many of the proposals taken in isolation are only partial fixes of a system crying out for a complete overhaul. In fairness, Valentine, Carter and Man, and the Senate, agree that the current law is deficient. The "own activities" test is an oversimplified legislative artifice that is ineffective, contradictory, and confusing.[50]

The fundamental problem is in the piecemeal drafting of the income tax rules on registered charities, and the ill-conceived reference to the concept of "activities carried on by the organization itself".[51] Any amendment that does not look at a comprehensive overhaul of the regulations that affect charities is just one more added patch on a system that already forces both charities and the CRA into obscurantist intellectual exercises.

(d) Terrorism Financing

One issue that has been given short shrift in the Senate Report is that of terrorism financing.[52] It is crucial to any discussion of reform in this area. It is not only an issue that significantly underlies the existing CRA approach to monitoring charities' operations outside Canada,[53] but it will inform any change to the current rules. It is a practical, political, and international relations issue.[54]

---

[49] *Contra,* Iacobucci J., writing for the majority, at para. 152, *Vancouver Society of immigrant and Visible Minority Women,* (1999) 1 S.C.R., 10.

[50] T. Carter and T. Man, *op. cit.* p. 46

[51] Senate Report, *op. cit.,* comment by A. Parachin at p.95., T. Carter and T. Man, *op. cit.,* p. 46, A. Valentine, *op. cit., passim,* but more specifically p. 9.

[52] Senate Report, *op. cit.,* p. 96. A. Valentine, *op. cit.,* does acknowledge it is a concern, although it is not extensively discussed.

[53] T. Carter and T. Man, *op. cit.*, p. 11.

[54] Canada is a participating member in the Financial Action Task Force (FATF), an intergovernmental organization created in 1989 as an initiative of the G7 countries, to combat money laundering and terrorism financing. In 2010, FATF issued eight special recommendations for its member countries on terrorism financing. One of these, recommendation VIII, deals specifically with terrorism financing through non-profit organizations. See Financial Action Task Force*, Best Practices Paper on Combating the Abuse of Non-Profit Organizations (Recommendation 8)*, Paris, FATF/Organization for Economic Cooperation and Development, 2015, 68 pages. https://www.fatf-gafi.org/media/fatf/documents/reports/BPP-combating-abuse-non-profit-organisations.pdf, notably at pp. 39, 42, 43, 44 and ff.

Indeed, an approach that simply involves leaving funds in the hands of a foreign organization carries a higher risk of malfeasance, and a lowered ability by CRA to monitor and enforce.

Despite theoretical arguments to the contrary, it is both impossible and impractical to separate investigations into terrorism financing on the one hand, and CRA monitoring of Canadian charities' operations abroad.[55] Some argue that other jurisdictions have more flexible approaches to charities operating abroad, and still deal effectively with terrorism. However, this overlooks the fact that Canada may not have the same mechanisms to detect or prevent terrorist financing. This warrants further exploration.

Using the existing policy, the Canadian security establishment can, through the CRA, address terrorism financing concerns without compromising classified information and investigative techniques. If the rules for Canadian charities operating abroad were to move to an "expenditure responsibility" model as opposed to the existing operational monitoring, the legal distance between the Canadian charity and the malfeasance occurring abroad would render investigations and revocations much more difficult. Authorities would have to rely much more on cumbersome collaboration and exchanges of classified information with other states, with higher attendant risk. They would have to place greater reliance on the onerous process of the *Charities Registration (Security Information) Act*.[56]

Indeed, internal sources have opined that under a hypothetical "expenditure responsibility" system, none of the past revocations of charities for involvement in terrorism financing would have succeeded because of the legal barriers between the Canadian charity and the foreign operations on the ground. In effect, during the past years, charities involved in terrorism financing were revoked for failing to comply with the policy as expressed in CG-002, leaving the whole terrorism issue and its attendant controversy and complexity unaddressed.

One problem is that, even if we accept that terrorism financing arises as a concern only in a fraction of Canadian charities funding operations abroad, there is no easy way to challenge the views expressed by the security authorities.

The other side of this issue is that the Senate Report arguably states that malfeasance can occur just as much under the current rules as it could under the proposed ones because it is so hard to detect. Indeed, any policies regulating how charities can operate abroad may help prevent inadvertent mismanagement of funds, but they are ineffective at preventing deliberate malfeasance. The CRA and the security establishment should not construe the existing or new rules as a kind of no-risk insurance for the government. A charity can't be the insurer of activity for the government's benefit. But yet, the issue for government remains that of preventing and thwarting terrorism financing through charities.

This paper cannot offer a solution but wants to signal that this conundrum is a potential, significant impediment to a more flexible approach and an area for further research.

[55] T. Carter and T. Man, p. 30 and ff.

[56] S.C. 2001, c. 41.

8. Conclusion

Exploration of this topic leads, perhaps inevitably, to a renewed call for a wholesale review of the rules in the *Income Tax Act* relating to charities. Will an amendment to the *Income Tax Act* on "own activities" and "direction and control" eliminate problems that charities are currently facing? No. The devil, as one might say, is in everything.[57]

Even if reform is limited, the barriers to a less burdensome approach to Canadian charities operating abroad remain: the cumbersome, piecemeal and often confusing approach that underscores the current provisions; the security establishment's concern over terrorism financing; and the tendency of auditors to view as unacceptable any potential for abuse in the structure of the charity's relationship with a foreign entity.

Placing the registered charity regulatory regime in the *Income Tax Act*, as done in Canada, inevitably has cost/benefit consequences. Tax policy considerations wouldn't exist if the regulatory regime were outside the ITA. And in a taxing context, the generous tax treatment of charities and their donors become central concerns. Efforts to ensure a "closed" system mean some bona fide charitable work will not occur because measures to prevent tax abuse dissuade or prevent registered charities from undertaking legitimate projects. Though less transparently, provisions intended to address security fears have a similar effect.

The Courts have held that charities operating abroad must and can meet the same public benefit requirement as if operating in Canada

Policymakers must use evidence-based risk analysis in designing any approach. The goal is to strike an appropriate balance between not hindering or thwarting charitable work because of tax leakage and security considerations and curtailing illicit activity. Currently, it would seem anecdotally, that legitimate activity is significantly hobbled for the sake of preventing improper conduct that is relatively minor in scope.

The Senate Report is a welcome first step. More and fuller discussions are needed. As is clear from the analysis above, the participation of Finance Canada, Global Affairs Canada, and the security establishment in such talks is essential to coming up with a viable and lasting way forward.

[57] Étienne Plamondon-Émond, « Plaidoyer pour une modernisation des règles », La Presse, November 13, 2019

The Pemsel Case
FOUNDATION

Suite 1150, 10060 Jasper Avenue,
Edmonton, Alberta, T5J 3R8

www.pemselfoundation.org