

## **2010 Fall Report of the Auditor General of Canada**

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### Chapter 7—Registered Charities—Canada Revenue Agency

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## Chapter 7—Registered Charities—Canada Revenue Agency

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## Main Points

### What we examined

There are more than 85,000 registered charities in Canada. They are exempt from paying tax on their income, and the federal government allows taxpayers to claim a tax deduction or a tax credit for charitable donations to reduce the income tax that they pay. For 2009, the estimated cost to the federal government of providing tax relief to individuals for charitable donations was almost \$2.4 billion.

The Canada Revenue Agency administers the *Income Tax Act*, including the provisions that relate to registered charities. To fulfil its role with respect to registered charities, the Agency defines its responsibilities as processing applications for registered charity status, carrying out audit and compliance activities, offering advice and guidance on complying with requirements of the Act, and providing general information to the public.

We examined how the Agency encourages compliance with the provisions of the *Income Tax Act* that relate to registered charities. We also looked at how the Agency deals with tax shelter gifting arrangements. These arrangements typically promise taxpayers (or “participants”) that they can buy property, donate it, and receive a donation tax credit that is worth more than the amount they originally spent to purchase the donated property. Promoters of tax shelters are required to obtain an identification number from the Agency before they can sell, issue, or accept consideration from participants.

Audit work for this chapter was substantially completed on 8 June 2010.

### Why it’s important

To many Canadians, charities play an important role in society. They provide services that people might otherwise expect the government to provide. Canadians can volunteer for causes important to them, or make donations to those charities that they want to support.

The Agency’s role is to ensure that charities comply with the measures in the *Income Tax Act*, so that their activities will achieve the charitable purposes for which they have been created.

As part of its role in protecting taxpayers by preventing abuses, the Agency has announced that it is reviewing all tax shelter-related gifting arrangements. It plans to audit every participating charity, promoter, and participant and has issued a number of news releases warning taxpayers about the arrangements. Tens of thousands of taxpayers have invested in these arrangements. Although very few registered charities are involved with tax shelter gifting arrangements, their actions could impact the whole charitable sector and cause some donors to stop making donations to those charities that are not involved in abusive tax shelters.

### What we found

- The Agency’s process for registering charities is thorough. The controls in place are adequate to monitor and manage the process for approving an organization’s application for registered charity status. This process is important because it may be the most in-depth involvement the Agency has with a charity during its life cycle.
- More than 33,000 charities did not file their annual information returns on time in 2008. The Agency posts certain information from these returns on its public website. Donors can visit the Agency’s website to check that a charity is registered and see select operating and board member information. Agency policy for dealing with charities that file their annual returns late is to issue reminder letters and de-register the charity after 10 months. Between 2007

and 2009, over 3,000 charities had their registration revoked for failure to file their returns. Most charities did file their returns once they received reminders.

- The Agency carries out random and risk-based audits to verify that registered charities remain in compliance with the *Income Tax Act*. In cases of non-compliance, the Agency has a range of tools and sanctions it can apply, ranging from education letters and negotiated agreements to intermediate and serious sanctions. However, although it has guidelines and references to sanctions in its audit manuals, it lacks sufficiently detailed internal guidance. During the period under audit, it continued to use mostly education letters, compliance agreements, and revocations; two charities were assessed intermediate sanctions.
- The Agency's communication to charities and donors is good, with information accessible through several channels, such as on the Agency website; by telephone, webcasts, and outreach programs; and on paper. For example, users can use the Internet, mail, or telephone to check whether a charity is currently registered, under suspension from issuing tax receipts, or has had its charitable status revoked. The Agency also has processes to ensure that the information it adds to its website is accurate and feedback mechanisms to verify that users' information needs are being met.
- The Agency has expressed concerns with some tax shelter gifting arrangements and has issued general warnings about them. The number of active tax shelter gifting arrangements is declining, but people continue to invest in them, a total of 172,300 by 31 December 2009. The Agency has audited many of them and by 31 March 2009, it had reassessed the amount of charitable donations claimed by over 69,000 participants who had invested in these arrangements.

**The Agency has responded.** The Agency agrees with all of our recommendations. Its detailed responses follow the recommendations throughout the chapter.

## Introduction

7.1 Canada has over 85,000 registered charities that provide assistance related to the relief of poverty, the advancement of education or religion, or other activities that are beneficial to communities. These charities rely on millions of volunteers, as well as paid staff in some organizations, to carry out their activities.

7.2 The federal government supports registered charities by allowing tax deductions or credits for charitable donations, which will reduce donors' income taxes. In addition, registered charities do not pay income tax. The cost to the federal government of providing tax relief to individuals for charitable donations was estimated to be almost \$2.4 billion for 2009. The Department of Finance Canada estimates the impact of this provision annually (Exhibit 7.1).

Exhibit 7.1—The estimated cost of providing tax relief to individuals for charitable donations exceeds \$2 billion each year

Year	Cost (\$millions)
2006	2,480
2007	2,495
2008	2,380
2009	2,380

Note: The figures were not audited by the Office of the Auditor General.  
Source: Tax Expenditures and Evaluations 2009, Department of Finance Canada

Administration of the provisions of the Income Tax Act that relate to registered charities

7.3 The Canada Revenue Agency is responsible for administering the provisions of the *Income Tax Act* that relate to registered charities. To fulfill this role, the Agency lists the following among its responsibilities, carried out primarily by its Charities Directorate:

- processing applications for registration,
- offering technical advice on operating a charity,
- handling audit and compliance activities, and
- providing general information to the public.

7.4 The Agency does not monitor provincial responsibilities, such as the governance and management of charities, and the role of the board of directors.

7.5 The Agency has approximately 41,000 employees. Of those employees, 270 are in the Charities Directorate; another 40 in seven Tax Services Offices are responsible for audits of registered charities that are located across Canada. In 2009, the budget for the Charities Directorate was \$23 million, of the Agency's total budget of \$4.3 billion.

Regulatory reform

7.6 In 2000, the government formed the Joint Regulatory Table, a working group comprising voluntary sector members and federal officials. It was convened under the Voluntary Sector Initiative to study and make recommendations for improving the voluntary sector's legislative and regulatory environment.

7.7 The final report, *Strengthening Canada's Charitable Sector: Regulatory Reform (2003)*, examined the federal regulation of charities and looked at options for change in the following four key areas:

- accessibility and transparency of the federal regulator, including making information it holds about charities available to the public;
- better access to appeals for organizations that disagree with decisions made by the regulator;
- compliance reforms, such as the possibility of introducing new sanctions to ensure charities meet their legal obligations; and
- possible institutional reform models for the federal regulator (for example, considering whether a charity commission should be the federal regulator of charities or whether a new voluntary sector agency should be created to work with the Agency).

7.8 In the 2004 federal budget, the government responded to the majority of the Joint Regulatory Table's 75 recommendations by making a number of amendments to the *Income Tax Act* in the following areas:

- a new compliance regime,
- a more accessible appeals regime,
- improved transparency, and
- more accessible information.

Focus of the audit

7.9 The objective of the audit was to determine whether the Canada Revenue Agency had processes designed to increase compliance with the charities provisions of the *Income Tax Act*. The Agency has stated that it is committed to increasing compliance in areas of tax regulation by providing strong taxpayer assistance.

7.10 We looked at how the Agency administers the provisions of the *Income Tax Act* that relate to registered charities and examined the processes the Agency has to deal with certain tax shelter gifting arrangements that use registered charities. The audit also looked at how the Agency communicates with charities and donors.

7.11 We examined the processes in place for the 2006–07, 2007–08, and 2008–09 fiscal years. In addition, we tested the controls for processing applications for registration as a charity, reviewed the Agency’s risk assessment and audit planning, and examined how the Agency considered the results of those activities. We also analyzed the application of penalties according to the *Income Tax Act*. For tax shelter gifting arrangements, we evaluated how the Agency communicated with potential participants, and whether it had a process for determining the tax shelters’ compliance with the *Income Tax Act*.

7.12 More details on the audit objectives, scope, approach, and criteria are in **About the Audit** at the end of this chapter.

## Observations and Recommendations

### Registered charities

7.13 The *Income Tax Act* defines a registered charity as a charitable organization, or private or public foundation that meets certain criteria for registration. To be a charitable organization, an organization must devote all resources to charitable activities, which it carries out itself. A charitable foundation (public or private) must be constituted and must operate exclusively for charitable purposes. As the Act does not define the terms “charitable activities” or “charitable purposes,” the Canada Revenue Agency relies on the common law definition, which describes a charity as an organization established for any of the following four purposes:

- the relief of poverty,
- the advancement of education,
- the advancement of religion, and
- other purposes beneficial to the community in a way the law regards as “charitable.”

7.14 Examples of organizations with charitable purposes include soup kitchens; universities; organizations that provide scholarships, bursaries, and prizes for scholastic achievement; religious bodies (when their activities serve religious purposes for the public good); and organizations that provide counselling services for people in distress.

7.15 Although other organizations operate to benefit a community in a popular sense, they do not meet the definition of a registered charity in the legal sense. For example, organizations such as social clubs, trade unions, and condominium corporations, although not established to earn a profit, are not charitable and cannot be registered as a charity. They may be exempt from paying income tax but are not able to issue receipts for donations.

The registration process is thorough

7.16 In order to approve an application for registration, the Canada Revenue Agency needs to have a process designed to ensure that the organization applying for registration meets the *Income Tax Act* requirements. If an organization does not qualify, it should be informed of the reason and told how

it can appeal the decision. An organization cannot issue donation receipts until it has received registered charity status.

7.17 When an organization applies to be a registered charity, it fills out an application form and submits it to the Agency. The application includes information about the organization's charitable purposes, activities, and operating budget, as well as information about its officials. The organization must also submit governing documents, such as articles of incorporation. These documents must include a description of the activities that the organization will undertake to achieve the charitable purposes for which it has been established.

7.18 When the Agency receives an application for registration, it examines the organization to ensure that its operations meet the legislative requirements of the *Income Tax Act*. The registration process is important because this may be the most in-depth involvement that the Agency has with the registered charity during its life cycle. Future Agency involvement may consist only of reviewing the charity's annual information reporting package and posting it on the Agency website.

7.19 We reviewed applications for registered charity status in a random sample of 45 files from a three-year period that ended 31 March 2009, to determine whether the Agency had controls in place and that they were operating effectively to monitor and manage the process to approve an organization for registered charity status. Our sample included applications for registration and for re-registration, some but not all of which were approved as registered charities. We considered whether

- decisions were reviewed and approved according to stated Agency policies,
- service targets published in the Agency's Annual Report to Parliament were met, and
- the organizations that were turned down were notified of their right to appeal.

7.20 When we tested these controls, we looked for evidence such as whether the Agency employee reviewed the application, determined that the purposes and activities would be charitable, did research where necessary, and issued the appropriate report, and also whether decisions were reviewed as appropriate. We found that the Agency's controls were adequate and functioning as intended, and that decisions were reviewed and approved.

7.21 The Agency has new registration service targets, which it published in its Annual Report to Parliament for the 2008–09 fiscal year. The Agency committed to responding to 80 percent of **simple applications** in two months, and to 80 percent of **regular applications** in six months. However, it did not meet these new service targets for either the 2007–08 or 2008–09 fiscal year (Exhibit 7.2). In order to meet these service targets, the Agency informed us that for the following year (2009–10) it took steps to deal with staffing shortages and a high inventory of charity files that needed to be processed. As a result, management indicated that performance has improved.

Exhibit 7.2—The Agency has not met its new registration service targets of 80 percent

	2006–07	2007–08	2008–09
Target for simple applications—80% response in 2 months	Not measured	42%	58%
Target for regular applications—80% response in 6 months	Not measured	53%	22%

Note: The figures were not audited by the Office of the Auditor General.

Source: Canada Revenue Agency Annual Report to Parliament, 2008–2009

Many registered charities file their annual information returns late

7.22 The *Income Tax Act* identifies many administrative activities that the registered charity needs to complete, such as

- preparing donation receipts for the correct amount in a prescribed fashion;
- maintaining books and records; and
- filing an annual Registered Charity Information Return (T3010), along with attachments and financial statements, on time.

7.23 The T3010 reporting package (return) is the only information the Agency requires a charity to submit annually in order to maintain its registered status. Registered charities must file the return within six months of the end of their fiscal period (year end). The Agency also asks the charity to inform it about changes to its mode of operation or legal structure. The Agency ensures that the returns are complete and watches for potential issues that would indicate the need for an audit. Equally important, donors can access certain information from the return that the Agency posts on its public website. The Agency does not post annual financial statements, but the public can request copies from the Agency.

7.24 The report of the Joint Regulatory Table stated that the best approach to deal with charities that file their annual returns late would be to list the non-filing charities on the Agency's website. The listing would indicate that the Agency would deregister the charity unless it filed the return by a certain date. This would lead to pressure from the local community to remind the charity of its legal obligation. The actual changes introduced to the *Income Tax Act* in 2004 to respond to these recommendations allow the Agency to publish the name of the late-filing charity only after it has charged a late-filing penalty of \$500.

7.25 The Agency's policy, however, is to charge the late-filing penalty only when it has revoked registration and the charity has reapplied for registration. As a result, only those organizations that have had their status revoked for failure to file are listed on the Agency's website, since the law allows a revoked charity's name to be disclosed. Consequently, it is not always apparent to the public that a charity's return is late and that information about a charity on the website may not be current.

7.26 The Agency's follow-up process for outstanding returns is to issue reminders and then revoke registration during the tenth month after the charity's year end. Data that the Agency provided indicates a slight increase in returns being filed on time—from 57 percent in 2007 to 59 percent in 2008. However, this still means that more than 33,000 (41 percent) of registered charities did not file their 2008 returns on time. Although most charities did file their returns once they received reminders, between 2007 and 2009 over 3,000 charities had their registration revoked for failure to file their returns.

7.27 **Recommendation.** The Canada Revenue Agency should evaluate whether its current process for dealing with annual information returns meets its objective of increasing compliance and receiving returns on time.

**The Agency's response.** Agreed. An evaluation of the current process for dealing with late-filed returns will be completed by September 2011.

Audits of registered charities ensure continued eligibility

7.28 To ensure that registered charities continue to comply with the *Income Tax Act*, the Agency has an audit and review process. It may select organizations for audit based on a review of the annual information returns, public complaints, and follow-up on past **compliance agreements**.



7.29 In its annual audit plan for registered charities, the Agency states that the plan is “designed to evaluate the level of compliance and the effectiveness of the Agency’s risk assessment system in identifying high-risk files.” The audit plan also indicates the Agency’s intent to audit one percent of registered charities every year. This includes files selected for audit based on an assessment of risk factors (targeted audits), as well as 150 random audits, which are discussed in the following section. The Agency initiates targeted audits when it identifies a potential high-risk issue.

7.30 Specialists at seven Tax Services Offices conduct detailed audits of files selected for review. In an audit, the Agency may look at records of donor receipts and amounts spent on charitable programs and administration to ensure that activities are still charitable. The Charities Directorate at Agency headquarters conducts smaller “desk audits,” consisting of a telephone call or a letter requesting information.

7.31 We reviewed the Agency’s results of its targeted and random audits. Between April 2006 and March 2009, the results of the almost 2,500 audits were as follows:

- 69 percent were clean or resulted in education letters (letters that explain the rules to a charity) being issued (least serious);
- 21 percent resulted in a compliance agreement; and
- 7 percent resulted in revocations (most serious).

The balance of three percent related to other types of audits, such as pre-registration audits.

7.32 These results indicate that the majority of the Agency’s audits of registered charities did not find serious non-compliance.

Random audits may not produce sufficiently reliable measures of compliance

7.33 In its annual Report on Plans and Priorities, the Agency committed to reporting a compliance rate for charities, beginning in its 2009–10 Performance Report.

7.34 With statistical sampling methods, it is critical to develop and execute a plan within pre-determined parameters, such as time period covered and file selection, and to have procedures in place to deal with missing or miscoded information. Although the Agency’s overall audit plan indicated its intent to conduct 150 random audits, we found no details indicating purpose, sampling methodology, or time frames for these random audits. As well, although the overall plan indicated that the Agency will conduct these audits each year, we found that the number of organizations selected for audit varied, with no justification for the number selected each year.

7.35 The Agency completed most random audits within the year planned, although a number of them were still in progress in the next fiscal year. For example, for the 2008–09 fiscal year, 158 files were selected and 20 of them were still incomplete by the 2009–10 fiscal year.

7.36 Without the implementation and completion of a random sampling plan, the Agency may not have statistically reliable findings on which to measure an overall compliance rate for registered charities.

7.37 **Recommendation.** The Canada Revenue Agency should develop and execute a random sampling plan to meet its commitment to report a compliance rate for registered charities.

**The Agency’s response.** Agreed. The Agency will develop a revised random sampling plan for implementation in the 2011–12 fiscal year.

The Agency does not have sufficiently detailed internal guidance to apply sanctions

7.38 Before regulatory reform, revoking charitable status was the primary sanction available to the Agency. The Joint Regulatory Table considered this to be too severe to be effective and recommended a sanctions regime that would encourage compliance with the law and have a range of penalties. The focus was to remediate the charities and work with them to develop solutions to problems as they arise.

7.39 This led to the addition of intermediate sanctions to the *Income Tax Act* in 2004, including an increased penalty for repeat assessment of certain issues. Exhibit 7.3 presents an overview of tools and sanctions and the Agency's description of them, listed from least to most severe.

Exhibit 7.3—The Agency has a number of tools and sanctions to encourage charities' compliance

<b>Tools and sanctions to obtain compliance</b>	<b>Description</b>
Education	<ul style="list-style-type: none"> <li>• Provide written advice through the Canada Revenue Agency website, publications, and education letters</li> <li>• Answer questions</li> <li>• Offer seminars</li> </ul>
Compliance agreement	<ul style="list-style-type: none"> <li>• Have discussions with the charity and sign a compliance agreement</li> </ul>
Intermediate sanctions	<ul style="list-style-type: none"> <li>• Impose financial penalties</li> <li>• Suspend the charity's status as a qualified donee, resulting in its inability to issue official donation receipts</li> </ul>
Serious sanction	<ul style="list-style-type: none"> <li>• Revoke the charity's registration resulting in its inability to issue receipts for donations and possibly becoming subject to paying income tax</li> </ul>
<p>Source: Canada Revenue Agency's website (<a href="http://www.cra-arc.gc.ca">www.cra-arc.gc.ca</a>), Guidelines for Applying the New Sanctions and Consequences of Revocation</p>	

7.40 The Agency takes a continuum approach to encouraging registered charities to comply with the *Income Tax Act*. The primary focus is on education, and the secondary focus is on monitoring and auditing the charities. If an audit finds a registered charity to be non-compliant, the Agency encourages the organization to improve by negotiating a compliance agreement that includes areas for improvement. Both the Agency and the charity sign the agreement, and the Agency follows up with another audit. If the charity does not respect the agreement, the Agency may apply intermediate sanctions. The ultimate sanction is for the charity to have its registered status revoked.

7.41 We examined whether the Agency had procedures and clear guidelines in place to determine which sanctions it should apply, and when, in order to ensure appropriate application of the *Income Tax Act*. Although the Agency has guidelines and references to sanctions in its audit manuals, which provide general descriptions, in our view, it does not have sufficiently detailed internal guidance for the application of these relatively new sanctions. Based on the existing guidance, the Tax Services Office carrying out the audit makes the decision to apply a sanction. The Director General of the Charities Directorate must approve intermediate and serious sanctions, but does not usually review cases where a sanction has not been applied.

7.42 During the period under audit, the Agency continued to use education letters, compliance agreements, and revocations as its most frequent tools to obtain compliance. There were 127 revocations for cause and two sanctions other than revocation in the three-year period of our audit.

7.43 **Recommendation.** The Canada Revenue Agency should evaluate the effectiveness of its use of various tools, such as sanctions and compliance agreements, to increase registered charities' compliance with the *Income Tax Act*. The Agency should also develop, document, and implement detailed internal guidance to clarify when and how sanctions should be applied.

**The Agency's response.** Agreed. The Agency is already evaluating the effectiveness of compliance agreements and will evaluate the effectiveness of its use of tools in the next two to three years.

The Agency has taken steps to develop internal guidance with respect to the application of sanctions and to strengthen the process for applying these sanctions. The Agency will continue to make improvements and will provide further guidance on the application of sanctions by March 2011.

The Agency's process for monitoring the appropriate disposition of a revoked charity's assets is informal

7.44 A registered charity may have its status revoked for a number of reasons:

- voluntary revocation, when it is winding up its operations;
- failure to file an information return; or
- revocation for cause, for example, for issuing a receipt for a gift or donation inappropriately, or for failing to keep books and records in Canada.

7.45 Between April 2006 and March 2009, approximately 5,850 charities had their status revoked, more than half due to returns not being filed. Voluntary revocations accounted for 46 percent, and revocations for cause were 2 percent of the total.

7.46 When the Minister issues a notice of intention to revoke the registration of a registered charity and revokes its status, the charity must transfer its net assets to an **eligible donee**, use the assets for charitable activities or programs, or remit those assets to the Crown within one year. The first two options are intended to encourage the use of the funds for charitable purposes, as opposed to requiring the charity to remit the funds to the Crown, since they were originally donated to the charitable organization.

7.47 The Agency is responsible for ensuring that the assets are disposed of according to the provisions of the *Income Tax Act*. It requires a tax return to identify the net assets and to indicate whether any assets were transferred to eligible donees or paid to the Crown. We found that employees use their personal email calendars to create lists of revoked charities to follow up on in one year to confirm that they have transferred assets as required. As these lists are in an individual employee's calendar, they may not be accessible by others. There is no centralized reporting or monitoring of Agency follow-up on revoked charities. This process lacks rigour and could result in inadequate follow-up.

7.48 **Recommendation.** The Canada Revenue Agency should develop and implement a formal process to ensure that it monitors consistently whether a registered charity has transferred its assets as required when its status is revoked.

**The Agency's response.** Agreed. The Agency will develop and implement a centralized monitoring process by the end of 2011.

The Agency communicates well with charities and donors

7.49 The report of the Joint Regulatory Table recommended a number of improvements related to educating the charity sector and the public. The Agency responded by

- introducing outreach programs,
- developing an education program, and
- increasing its client assistance.

7.50 The Agency provides charities and donors with information in a variety of formats to ensure accessibility. Guides and publications are available in hard copy and on the Agency website. The Agency maintains a toll-free telephone number dedicated to responding to charity-related queries. Webinars are held and there is an active charity outreach program. Overall, we found that the information is available in a variety of media and the Agency continues to develop user-friendly approaches to delivering information to targeted audiences.

7.51 A range of information is available to the general public about registered charities, such as contact information and a general account of the charity's activities. In addition, the Agency makes public selected annual return information once the charities file their returns. Registered charity status can be checked online, by mail, or by telephone to see whether a charity is currently registered, is under suspension from issuing tax receipts, or has had its charitable status revoked.

7.52 We examined whether the Agency has a process in place to ensure that the information it provides is accurate. As new information is put on the website, the Agency has a quality control process to ensure its accuracy. When revising or updating information to the website, as required, internal groups at the Agency, such as the Web Committee, Legal Services, and the Rulings Directorate, review the new information for accuracy.

7.53 The toll-free charity line has a service standard related to how quickly a telephone call is answered: 80 percent of calls must be answered within two minutes. The measurement provides the Agency with assurance that responses are accessible and timely. However, the Agency was not monitoring or evaluating the quality of the responses provided. In 2010, the Agency intends to add silent monitoring of random telephone calls to monitor the quality and consistency of the information provided.

7.54 As communication is an ongoing activity, it is important to evaluate the approach to ensure that user needs continue to be met. We found that the Agency solicits user feedback, with evaluations of individual information sessions and web-based feedback.

#### Tax shelter gifting arrangements

7.55 A **tax shelter** can be a legitimate way for a taxpayer to reduce taxes. In one type of tax shelter, called a "tax shelter gifting arrangement," a taxpayer (called a "participant") makes a donation to a charity through a tax shelter. The Canada Revenue Agency has expressed concerns about some tax shelter gifting arrangements and has issued a number of news releases and tax alerts warning taxpayers about them. In many cases, charities involved in these arrangements are issuing donation receipts in excess of the cash invested or property donated, and often the cash received is not used for charitable purposes.

7.56 One example of a tax shelter gifting arrangement is called a "gifting trust arrangement," in which the participant becomes a beneficiary of a trust and receives property as a distribution from the trust. The participant then donates this property along with an amount of cash to a registered charity and receives donation receipts for the total of the cash and purported fair market value of the property. Typically, the total cash the participant pays is about 30 percent of the amount on the donation receipt. The Agency has denied these types of donations in their entirety, taking the position that there was no gift.

7.57 The Department of Finance Canada released draft amendments to the *Income Tax Act* on 5 December 2003, to limit the tax benefits of charitable donations made under tax shelters and other arrangements. The amendments responded to concerns about these tax shelter gifting arrangements and addressed other changes proposed in the 2003 federal budget. The Agency's position was that the proposed legislation would reduce the donation to no more than the actual cash payment. Although the legislation died on the order paper in 2008 when Parliament was dissolved, it effectively put a stop to a type of arrangement called the "buy-low, donate-high" tax shelter gifting arrangement.

The Agency issues tax shelter identification numbers to all promoters of tax shelter gifting arrangements with complete applications

7.58 The *Income Tax Act* requires the **promoter** of a tax shelter to obtain a tax shelter identification number, the purpose of which is to allow the Agency to identify and track tax shelters and determine whether to audit them. A tax shelter may have multiple promoters.

7.59 The *Income Tax Act* requires the Agency to issue an identification number when the application contains certain required information such as a copy of an offering memorandum, and a statement that the promoter will keep the books and records in Canada. The Agency cannot audit the tax shelter gifting arrangement at the time it issues the identification number because the transactions have not yet taken place. It simply ensures the completeness of the application. As the Agency has received considerable information about the arrangement, it does a preliminary risk assessment to decide whether the arrangement is likely to be abusive and whether it should be audited at a later date.

7.60 The *Income Tax Act* requires that the following wording be put on every written statement that refers to the identification number of the tax shelter:

The identification number issued for this tax shelter shall be included in any income tax return filed by the investor. Issuance of the identification number is for administrative purposes only and does not in any way confirm the entitlement of an investor to claim any tax benefits associated with the tax shelter.

7.61 As of 31 March 2009, approximately 50 tax shelter gifting arrangements had obtained identification numbers since they were first required to do so in 2003. The number of active tax shelter gifting arrangements between April 2006 and March 2009 was 8 or 9 per year, and the number of new ones obtaining identification numbers each year has declined since 2003. Some promoters switched to new arrangements to get around the proposed legislative changes, and promoters continue to request identification numbers for arrangements that they claim comply with both existing legislation and draft legislative proposals.

The Agency issues general warnings to taxpayers about abusive tax shelter gifting arrangements

7.62 In 2007, the Agency introduced the Taxpayer Bill of Rights explaining what taxpayers can expect in dealing with the Agency. These include

- the right to privacy and confidentiality, and
- the right to expect the Agency to warn taxpayers about questionable tax schemes in a timely manner.

The Agency explains that taxpayers can expect it to provide timely and relevant information about questionable tax schemes that it intends to scrutinize so that taxpayers can recognize and avoid falling into tax schemes that could put them at odds with Canada's tax laws. The Agency states that it

strives to provide information that will help taxpayers understand how to protect themselves against tax schemes and understand the consequences they may face as a result of participation in them.

7.63 The Agency maintains that it cannot disclose names of tax shelter gifting arrangements, the promoters, or the charities involved before auditing them, due to the restrictions on disclosing taxpayer information under the *Income Tax Act*. The challenge for the Agency is to provide information that is timely and as detailed as possible regarding possibly abusive tax shelters, while respecting the confidentiality of the taxpayer information.

7.64 When it issues an identification number to a tax shelter gifting arrangement, the Agency does not communicate any concerns it may have with that specific arrangement to taxpayers. It uses tax alerts to provide only general cautions about arrangements the Agency considers questionable. The Agency has repeatedly warned taxpayers that tax shelter numbers are used for identification purposes only. In a 2008 Tax Alert, the Agency said:

A tax shelter with an identification number does not guarantee that taxpayers are entitled to receive the proposed tax benefits. Taxpayers should avoid all schemes that promise donation receipts for three to four times the cash payment.

7.65 We found that, given the Agency's interpretation of the limitations on the information it can disclose, the Agency has made reasonable efforts to warn taxpayers about abusive tax shelter gifting arrangements.

The Agency has reassessed tens of thousands of participants in tax shelter gifting arrangements

7.66 Despite the Agency's tax alerts and the promoter's mandatory disclosure, some taxpayers continue to invest in tax shelter gifting arrangements. The Agency estimated that, as of 31 December 2009, there have been approximately 172,300 participants in these arrangements, with \$5.4 billion in reported donations. The number of participants and the amount of donations claimed has been declining each year from a peak in 2006.

7.67 The Agency makes it clear that it intends to audit all those involved with tax shelter gifting arrangements—the promoters, the registered charities, and the participants. As of 31 March 2009, the Agency had completed over 69,000 reassessments of taxpayers who participated in tax shelter gifting arrangements and had denied almost \$2 billion in charitable donations.

7.68 A participant who disagrees with a reassessment has the right to object by filing a Notice of Objection with the Agency. Of those who are reassessed for participation in a tax shelter gifting arrangement, most file a Notice of Objection. If participants lose their appeal at the objection stage, they can proceed to court, and many of them do. We noted in at least one case that promoters discussed possible objections or court actions when marketing the tax shelters.

7.69 After the Agency conducts an audit of a registered charity that participated in a tax shelter gifting arrangement, it may revoke that charity's registration. The Agency may then issue a news release and post the information on its website. Between April 2006 and March 2009, the Agency issued 11 news releases about revoking the registration of charities participating in abusive tax shelter gifting arrangements.

7.70 For example, on 17 November 2008, the Agency issued a news release after revoking the charitable registration of a charity that had issued receipts for cash received from a tax shelter with an identification number. The Agency stated the following:

The Charity's sole activity during the audit period was its participation in the donation arrangement; no charitable activities have been conducted by the Charity prior to or after its participation aside from the gifting of approximately \$18,000 to qualified donees.

According to the Agency, the charity issued official donation receipts for cash and property in excess of \$6.7 million.

7.71 Although very few registered charities are involved with tax shelter gifting arrangements, their actions could have an impact on the whole charitable sector and cause some donors to stop making donations to those charities that are not involved in abusive tax shelters.

7.72 The Agency releases information about specific tax shelter gifting arrangements when the charities involved have had their registration revoked since the *Income Tax Act* permits this. However, this occurs after taxpayers have participated in the tax shelter gifting arrangement.

7.73 The Agency has made progress in reducing taxpayers' participation in tax shelter gifting arrangements, as seen in the decline in applications for tax shelter identification numbers and a decline in the number of participants and donations claimed. However, the industry still exists and the Agency must continue to invest time and resources to ensure that it stays on top of this issue. Some taxpayers will continue to buy into an arrangement that is too good to be true, despite the cautions of the Agency and the media.

## Conclusion

7.74 The Canada Revenue Agency has processes designed to increase compliance with the *Income Tax Act* related to registered charities. The registration process works well and is thorough. The Agency could improve its process for dealing with late-filed annual information returns, and it does not have sufficiently detailed internal guidance to apply sanctions. In addition, random audits may not produce reliable measures of compliance.

7.75 The Agency has designed processes to detect non-compliance related to tax shelter gifting arrangements, within the constraints of the *Income Tax Act*. The Agency identifies and audits tax shelter gifting arrangements. However, promoters continue to request and receive identification numbers if their applications are complete. Many taxpayers are reassessed for investments made in these arrangements.

7.76 The Agency's communication processes for charities and donors are well-designed. The Agency distributes information in a variety of media and focuses on educating charities and the public. For tax shelter gifting arrangements, the Agency issues tax alerts and news releases. However, it does not release specific information about questionable tax schemes when a tax shelter identification number is issued due to its obligation to maintain the confidentiality of taxpayer information.

## About the Audit

All of the audit work in this chapter was conducted in accordance with the standards for assurance engagements set by The Canadian Institute of Chartered Accountants. While the Office adopts these standards as the minimum requirement for our audits, we also draw upon the standards and practices of other disciplines.

### Objectives

The objective of the audit was to determine whether the Canada Revenue Agency had processes designed to increase compliance with the charities provisions of the *Income Tax Act*.

We conducted our audit with the following three lines of enquiry, each with its own sub-objective:

- **Registered charities.** Determine whether the Agency has processes designed to increase compliance with the Act related to registered charities.
- **Tax shelter gifting arrangements.** Determine whether the Agency has appropriate processes designed to increase compliance with the Act related to tax shelter gifting

arrangements.

- **Communications.** Determine whether the Agency's communication processes are designed to increase donors' and charities' level of awareness of the charities provisions of the Act.

### Scope and approach

The audit focused on three areas that deal with the administration of the charities provisions of the *Income Tax Act*:

- the activities that the Agency undertakes to register, monitor, and review registered charities;
- the process that the Agency uses to identify, monitor, and review tax shelters that use the charities provisions of the Act; and
- the way the Agency communicates the obligations, under the Act, of registered charities and entitlements of their donors.

In conducting our audit, we requested and reviewed documents and reports from the Agency. As well, we analyzed databases relating to applications for registration, audits planned and completed by the Agency relating to charities and tax shelters, and revocations and wind-ups. Our review of applications for registration included the random sampling of 45 files over the three-year period of our audit. Our sample was chosen in accordance with statistical sampling methodology to give a high level of assurance that controls were operating effectively. A sample size of 45 is sufficient to project the entire population of 12,031 with an expected error rate of 0 percent, a confidence interval of +5 percent, and a confidence level of 90 percent.

To confirm our understanding of the information we received, we interviewed Agency staff at various levels and locations. We visited four Tax Services Offices and conducted interviews with auditors, team leaders, and assistant directors of audit. At the Agency's headquarters, we met with staff in the Compliance Programs Branch, the Charities Directorate of the Legislative Policy and Regulatory Affairs Branch, and the Appeals Branch.

The audit did not examine Agency activities related to the following:

- provincial authorities on charities (governance issues),
- political contributions,
- non-profit organizations, and
- the Quality Management Framework for the accuracy of communications.

### Criteria

<b>To determine whether the Agency has processes designed to increase compliance with the <i>Income Tax Act</i> related to registered charities, we used the following criteria:</b>	
<b>Criteria</b>	<b>Sources</b>
The Canada Revenue Agency has a process that determines the eligibility of a potential registered charity.	<i>Income Tax Act</i> , subsections 149.1(1) and 248(1)
The Agency meets its established service targets for registration of simple and regular applications.	Canada Revenue Agency Annual Report to Parliament 2008–2009



The Agency has an audit and review process that determines a registered charity's eligibility for continued registration.	<ul style="list-style-type: none"> <li>• <i>Income Tax Act</i>, sections 149.1, 168, 230-231.5, subsection 220(1)</li> <li>• <i>Income Tax Regulations</i>, sections 3500–3504</li> </ul>
The Agency has incorporated risk management into its audit planning activities to identify current and emerging compliance threats.	Canada Revenue Agency Annual Report to Parliament 2008–2009
The Agency has a procedure in place that applies taxes and minor, intermediate, and severe penalties.	Budget 2004, Department of Finance Canada
The Agency has procedures in place that confirm the appropriate wind-up of a registered charity.	<i>Income Tax Act</i> , subsections 149.1(2)–149.1(4.1), 168(1), and 188(1.1)
<b>To determine whether the Agency has appropriate processes designed to increase compliance with the <i>Income Tax Act</i> related to tax shelter gifting arrangements, we used the following criteria:</b>	
<b>Criteria</b>	<b>Sources</b>
The Agency has an appropriate process in place that identifies tax shelter gifting arrangements.	<ul style="list-style-type: none"> <li>• <i>Income Tax Act</i>, section 237.1</li> <li>• <i>Income Tax Regulations</i>, subsection 231(6)</li> </ul>
The Agency has appropriate processes in place that detect questionable tax shelter gifting arrangements.	<ul style="list-style-type: none"> <li>• Taxpayer Bill of Rights</li> <li>• <i>Income Tax Act</i>, section 237.1</li> </ul>
The Agency has an appropriate process in place that applies penalties regarding tax shelter gifting arrangements.	<i>Income Tax Act</i> , subsections 163(2), 237.1(7.4), and 239(2.1)
<b>To determine whether the Agency's communication processes are designed to increase the level of awareness of donors and charities, we used the following criteria:</b>	
<b>Criteria</b>	<b>Sources</b>

The Agency's information regarding registered charities is accurate, accessible, and available in a timely manner.	<ul style="list-style-type: none"> <li>• Canada Revenue Agency Communications Policy</li> <li>• Budget 2004, Department of Finance Canada</li> <li>• Taxpayer Bill of Rights</li> </ul>
The Agency has evaluated and improved the communication process regarding charities and tax shelters.	Canada Revenue Agency Communications Policy
The Agency has a process to warn donors about questionable tax schemes.	Taxpayer Bill of Rights

Management reviewed and accepted the suitability of the criteria used in the audit.

Period covered by the audit

The audit covered the period from April 2006 to March 2009. Audit work for this chapter was substantially completed on 8 June 2010.

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## Appendix—List of recommendations

The following is a list of recommendations found in Chapter 7. The number in front of the recommendation indicates the paragraph where it appears in the chapter. The numbers in parentheses indicate the paragraphs where the topic is discussed.

Recommendation	Response
<b>Registered charities</b>	

<p><b>7.27</b> The Canada Revenue Agency should evaluate whether its current process for dealing with annual information returns meets its objective of increasing compliance and receiving returns on time. <b>(7.22–7.26)</b></p>	<p>Agreed. An evaluation of the current process for dealing with late-filed returns will be completed by September 2011.</p>
<p><b>7.37</b> The Canada Revenue Agency should develop and execute a random sampling plan to meet its commitment to report a compliance rate for registered charities. <b>(7.33–7.36)</b></p>	<p>Agreed. The Agency will develop a revised random sampling plan for implementation in the 2011–12 fiscal year.</p>
<p><b>7.43</b> The Canada Revenue Agency should evaluate the effectiveness of its use of various tools, such as sanctions and compliance agreements, to increase registered charities' compliance with the <i>Income Tax Act</i>. The Agency should also develop, document, and implement detailed internal guidance to clarify when and how sanctions should be applied. <b>(7.38–7.42)</b></p>	<p>Agreed. The Agency is already evaluating the effectiveness of compliance agreements and will evaluate the effectiveness of its use of tools in the next two to three years.</p> <p>The Agency has taken steps to develop internal guidance with respect to the application of sanctions and to strengthen the process for applying these sanctions. The Agency will continue to make improvements and will provide further guidance on the application of sanctions by March 2011.</p>
<p><b>7.48</b> The Canada Revenue Agency should develop and implement a formal process to ensure that it monitors consistently whether a registered charity has transferred its assets as required when its status is revoked. <b>(7.44–7.47)</b></p>	<p>Agreed. The Agency will develop and implement a centralized monitoring process by the end of 2011.</p>

Definitions:

**Simple applications**—Complete applications with charitable purposes and activities; these applications meet all of the other requirements of the *Income Tax Act* and require no further detail. (Return)

**Regular applications**—Applications that require research and additional information from the applicant before the Canada Revenue Agency can determine whether or not the organization qualifies for charitable registration. (Return)

**Compliance agreement**—A formal document signed by both the Canada Revenue Agency and the charity to correct previously noted problems. (Return)

**Eligible donee**—A registered charity of which more than 50 percent of the members of its board of directors or trustees deal at arm's length with each member of the board of directors or trustees of the charity that has been sanctioned or revoked. It must also not be under suspension and must have filed all its information returns, among other criteria. (Return)

**Tax shelter**—A tax shelter may be an investment in property or a gifting arrangement (an arrangement where a participant makes a gift of property acquired to a qualified donee, typically a registered charity).

It is a tax shelter if it is promoted as offering income tax savings; the buyer or donor will have losses, deductions, or credits within the first four years; and the losses, deductions, or credits would be equal to or more than the net cost of the investment or of the property acquired under the gifting arrangement. (Return)

**Promoter**—The person(s) who

- sells, issues, or promotes the sale, issuance, or acquisition of the tax shelter;
- acts as an agent or advisor; or
- accepts consideration in respect of the tax shelter. (Return)