



## Canadian Charities and Canada Revenue Agency (CRA) Audits<sup>1</sup>

By Mark Blumberg (January 14, 2008)

The Charities Directorate of Canada Revenue Agency (“CRA”) is required to monitor the operation of Canadian registered charities and they audit the charities as part of this obligation. In a typical year, CRA conducts approximately 800 audits across Canada. Audits are common but that being said, there is nothing like hearing the word “audit” to cause fear and trepidation amongst Canadian charities, especially if the word audit is being used in connection with your own charity. The extreme anxiety that charities may feel is frequently unwarranted unless the charity is planning on being uncooperative or has been involved in serious, deliberate and willful transgressions of the *Income Tax Act*.

About 600 of these are field audits and 200 are office audits. The difference between an office audit and a field audit is that an office audit is conducted at the CRA headquarters and not at the charity’s place of business. Additionally, at an office audit, the auditors are only reviewing the documents in the CRA file and other documents requested by CRA of the charity. In a field audit, the auditors are attending at the charity office, or some other agreed upon location, and examining not only financial information, such as ledgers, journals, bank accounts, expense accounts, investments etc., but also other documents including contracts, governing documents, annual reports, minutes and any other documents that relate to the charity’s activities. They sometimes ask questions while attending at the charity’s office and request clarifications.

There are many reasons a charity may be picked for audit including: random selection; a complaint about the charity from the public; a red flag from a T3010 filing; involvement with an abusive tax shelter; follow-up on a previous audit or compliance issue; or a CRA review of a particular segment of the charitable sector<sup>2</sup>.

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<sup>1</sup> This article deals with audits conducted by the Canada Revenue Agency on a Canadian registered charity with respect to obligations under the *Income Tax Act* and not other types of audits such as GST, EI/CPP.

<sup>2</sup> Currently CRA is interested in: Canadian charities that conduct foreign activities; charities with high fundraising costs (eg. 80% per year); abusive charity tax shelter donation schemes in which the charities

Except in the case of very serious non-compliance, for example, fraud or deliberate attempts to not cooperate with the regulator, CRA takes an “education first” approach. If CRA wanted to deregister charities for non-compliance with the *Income Tax Act*, they would have little difficulty deregistering many charities when one looks at the statistics on non-compliance below.

According to CRA, in the 2007-2008 fiscal year, 790 audits were conducted. The audit findings reveal challenges facing registered charities, including:

- 89% had incomplete or incorrect official receipts;
- 72% had incomplete T3010 Registered Charity Information Returns;
- 71% had insufficient books and records;
- 16% made gifts to non-qualified donees; and
- 13% carried out non-charitable activities including excessive amounts of resources being devoted to non-charitable activities (fundraising, political, or social activities).

According to statistical information kept by CRA on the audits they have conducted, approximately 23% of the organizations were essentially compliant; about 50% were provided with an educational letter, 19% were required to complete a compliance agreement and 4% of the organizations’ had their charitable status revoked for cause and another 4% had other outcomes. Given that quite a large number of the audits are conducted on high-risk charities, the fact that only 4% resulted in revocation is actually a very low number and shows that CRA is committed to educating rather than revoking non-compliant charities. In the past, CRA’s only remedy for non-compliance was revocation and they did not use it frequently as we can see above.

For further breakdown of non-compliance that CRA routinely finds you can see a good presentation by Terry De March, Director General of the Charities Directorate at [http://www.globalphilanthropy.ca/images/uploads/Top\\_Ten\\_Compliance\\_Issues\\_-\\_Terry\\_de\\_March\\_Director\\_General\\_November\\_2007.pdf](http://www.globalphilanthropy.ca/images/uploads/Top_Ten_Compliance_Issues_-_Terry_de_March_Director_General_November_2007.pdf)

In fact, with many charities their non-compliance is relatively obvious to an experienced practitioner from simple review of public sources such as corporate searches, T3010 filings and their websites. In the past CRA really only had one bullet in its arsenal and that was revocation. Consequently few charities had their registration revoked because of the seriousness and finality of such an action. For many charities that would be the equivalent of capital punishment. With introduction of intermediate sanctions and its

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issue a large dollar amount of receipts but have little activities etc.; fraud involving the sale of charitable receipts, charities that are conducting either partisan political activities or more allowable political activities than permitted under the *Income Tax Act*.

availability to CRA, it is likely that CRA will use more of the intermediate sanctions including penalties for non-compliance. It is advisable for charities to carefully review their operations to ensure compliance with their legal obligations.<sup>3</sup> This review is best handled when there is no urgency and an upcoming CRA audit, however, charities, just like other entities and people often procrastinate till the end.

## **How To Handle a CRA Charity Audit**

Here are some suggestions when handling a CRA audit of a registered charity:

- 1. Respond Quickly.** It is very important when a CRA auditor contacts you that you promptly respond. If they are requesting an inspection, you should comply and arrange for it. Whatever you do, do not ignore CRA.
- 2. Be Cooperative and Polite.** Although you would think this is an obvious point – if you obfuscate and obstruct expect that CRA will not be amused – they may dig further to see why you are being difficult and will certainly be less sympathetic if they find irregularities.
- 3. Use Your Time Wisely Before the Audit.** From the time CRA advises that you are being audited and the time they meet with you, weeks may pass. During this period, it would be ideal for you to obtain legal advice with respect to any concerns you may have and to review certain matters that you may not be concerned with, but CRA will be focusing on. I find that clients are more “motivated” after receiving an audit letter to deal with some outstanding issues that they probably should have dealt with before. There is nothing like having an auditor coming to visit to encourage you to be more compliant with the requirements of the *Income Tax Act*. You can use this valuable time to beat your head against the wall and scream and cry about the unfairness of why your charity is being audited, or you can be oblivious as you are certain that your charity is 100% compliant with all legal aspects under the Income Tax Act etc., or you can do something more productive! You may wish to contact a charity lawyer who is knowledgeable about the operations of the charity to conduct a brief informal legal review which can, in many cases, pick up many of the problems that CRA will discover if they are not rectified. Some issues can be resolved prior to CRA conducting their audit which saves CRA having to tell you to fix the problem.

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<sup>3</sup> See my article on the advisability of informal legal audits at

[http://www.blumbergs.ca/images/uploads/Canadian\\_Non\\_Profit\\_and\\_Charity\\_Legal\\_Audits\\_-\\_Forget\\_about\\_it.pdf](http://www.blumbergs.ca/images/uploads/Canadian_Non_Profit_and_Charity_Legal_Audits_-_Forget_about_it.pdf) and my article on informal legal audits of foreign activities at  
[http://www.blumbergs.ca/images/uploads/RC4106\\_Legal\\_Audit.pdf](http://www.blumbergs.ca/images/uploads/RC4106_Legal_Audit.pdf)

Other improvements in compliance can be started even though they will not be completed by the time of the audit. Diligent attempts by an organization to become compliant will not be viewed negatively by CRA and will improve the chances of maintaining a legally compliant and sustainable organization.

- 4. Choose Carefully Which Charity Officer or Employee Represents the Charity with CRA.** The obnoxious bully who nobody in the office likes is probably not the best point person for dealing with CRA. Nor is the 'know it all' employee who will educate the CRA representative on the *Income Tax Act*. Select someone to represent your organization who understands why CRA is there, is careful with what they say, and is professional, polite and helpful.
- 5. The Lawyer is Generally Best Kept in the Background.** Some clients would prefer if a lawyer is involved directly with CRA. However, it is unnecessary, costly and sends the wrong message in terms of the level of concern of the charity with regard to the audit. Generally, it is best if the organization deals directly with CRA with the assistance of their bookkeeper or accountant and if necessary, later, the lawyer can be engaged more directly. Picking the appropriate legal counsel is one of the most important decisions that a charity makes.<sup>4</sup> Not only with that legal counsel assist with advice relating to the initial attendance on the audit and response to queries from CRA, but also changes that the organization may require as a result of the audit and subsequent ongoing advice.
- 6. Have Your Records Up-to-date.** Ideally charities should keep their books and records in an orderly fashion and up-to-date. However, this is not always the case, with many charities being run by volunteers or overwhelmed staff. If records are not as up-to-date and organized as they should be then this is something to work on prior to the audit. Do you have a minute book with all your documents handy? If the CRA has requested that you produce certain documents, are they available? It is ideal to provide CRA private space in your office to conduct the audit so they can be in and out as quickly as possible without being bothered by others or distracted by scintillating conversations.
- 7. Answering Questions at the Audit.** As discussed above many charities are non-compliant on some point or another. When you are asked a specific question, if you know the answer, then answer it truthfully. As well, if you are not sure of the answer then let CRA know. You can either find out the answer and advise CRA

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<sup>4</sup> My article, [http://www.globalphilanthropy.ca/images/uploads/How\\_Can\\_Canadian\\_Charity\\_or\\_Non-profit\\_obtain\\_cost\\_effective\\_and\\_useful\\_legal\\_services\\_from\\_a\\_lawyer.pdf](http://www.globalphilanthropy.ca/images/uploads/How_Can_Canadian_Charity_or_Non-profit_obtain_cost_effective_and_useful_legal_services_from_a_lawyer.pdf) may assist in thinking about which legal counsel may be appropriate for your charity. Essentially some lawyers have a bone to pick with CRA. If you want to be that bone then you may want to pick them.

later, or you can request that CRA provide a written request for the information with which you can respond. If you had done something in the past that was not correct and you have subsequently changed the way you operate, let CRA know about your new procedures or documents when they ask about the past non-compliance. Whatever you do, do not lie or attempt to mislead.

8. **To provide documents or not to provide documents, that is sometimes the question.** It is not helpful for both the charity and CRA for the charity to just dump lots of documents on the auditor. The auditor may assume you are trying to hide something by drowning them in documents. As well, if the auditor looks carefully through those documents they may find things they were not even looking for. Provide the auditor with only the documents the auditor requests. This is ultimately beneficial for the charity and the auditor. As well, CRA is not entitled to and cannot obtain certain documents such as those that are legitimately solicitor-client privileged. For example, CRA cannot require that you hand over correspondence that your lawyer sent you advising that your transfer of funds to a foreign charity which is not a qualified donee undertaken without an agreement or directions and controls is inappropriate. Yes, they also cannot get a copy of the other letter you got from a lawyer who does not know much about charities saying that those activities seem just fine to him! Solicitor-client privilege does not apply to communications between an accountant or bookkeeper and a charity. Consequently, it may be detrimental to the charity prior to an audit to request that their accountant prepare a memo outlining all irregularities! That may be going overboard in assisting CRA in its regulatory responsibilities! Occasionally, and usually unintentionally, CRA requests documents that they are not entitled to. Keep in mind that CRA has relatively broad powers to request information relating to the charity. Just about everyone knew that CRA has broad powers to request information, but for the few that did not, it has been confirmed by the *Redeemer* case. Also, remember that if you want to play a game of cat and mouse, you as the charity are unfortunately the mouse. I am not sure who is the cat, whether CRA or some legal advisor charging by the hour!
9. **Copying of Documents.** It is preferable once the auditor has requested copies of documents from the charity for the charity to immediately copy those documents and provide the copies to CRA, not originals, and keep records of which documents have been provided to CRA so that your legal counsel, if necessary, can easily review the documents in CRA's possession. Alternatively, CRA can remove the documents, photocopy them and return them to you. This is less than ideal as the records you require to run your organization will be with CRA and this could prove to be disruptive. In addition, if CRA will be removing documents it is best to itemize exactly what documents they are taking.

**10. Preliminary Discussions.** Auditors will generally discuss their preliminary findings verbally with the charity when onsite before submitting a report to headquarters. Take notes on what the auditor is suggesting or concerns raised by the auditor so that you can discuss these with your board and legal counsel. Often you will want to not wait months or years before dealing with potential non-compliance and knowing what the CRA auditor is concerned with may be helpful in beginning the process of dealing with any non-compliance.

**11. CRA Requesting Additional Documents or Information.** CRA may come back months or even years later requesting additional information or documents. Do not assume that because you have not heard anything from CRA for months or years that the audit is over. As well, charities that are audited once are more likely to be audited again – do not assume that because the only result from CRA is an educational letter that that is some sort of official certification that your charities activities are legally compliant.

### **Five things you should avoid doing before an audit**

My editor, Lisa, did not think that I should include this short list because they are ‘obvious’. But as I have seen or heard of each of them, I think it may be useful just to remind people of some obvious points so here are my five things you should NOT do:

1. Avoid answering the phone or replying to letters.
2. Destroying documents.
3. Creating fictitious new documents that are backdated.
4. Writing rude letters to CRA.
5. Hiring someone to write rude letters to CRA on your behalf.

### **CRA Response After the Audit is Completed**

After the audit has been conducted there are various possible responses from CRA including:

#### **Confirmation of Compliance (17% of charities audited)**

1. Letter sent to the charity advising that the charities operations and activities appear to be in compliance with the *Income Tax Act* and there is no change to the charity’s registered status.

#### **Education Letters (53% of charities audited)**

2. An education letter does not affect the charities registration but identifies certain areas of concern that CRA has and provides guidelines to the charity to take steps to become more compliant.

### **Administrative Fairness Letter**

3. If the violations of the *Income Tax Act* are serious then CRA will send a letter to the charity. The letter is sometimes called an “administrative fairness letter”, or AFL, and it gives the charity an opportunity to make a representation as to why CRA should not revoke the charity’s registration or take other serious measures. Before entering into a compliance agreement, assessing penalties or revocation CRA will send the AFL. If the charity does not respond or the response does not satisfy CRA, then CRA will move to the next step including compliance agreement, penalty or deregistration. The administrative fairness letter is never the final decision but provides the preliminary position of CRA. Even when CRA is suggesting penalties, sanctions etc, you have an opportunity to respond. The organization can refute the CRA's position, offer to correct non-compliance to avoid a penalty and even argue that a lesser penalty is more deserving. All of this is weighed by CRA before they make a final decision.

### **Compliance Agreements (18.5% of charities audited)**

4. In cases that are more serious than an educational letter CRA can request the charity to enter into a compliance agreement. In the past, these were referred to as an undertaking letter. This also does not affect the registration of the charity, but a compliance agreement sets out the issues of concern and the actions that CRA are requiring as well as any timelines or consequences if the charity fails to abide by the agreement. Both CRA and the charity must sign the agreement and CRA will follow up with the charity to ensure that it complies with the agreement. Charities that sign a compliance agreement are held to a higher standard with respect to the subject matter of the agreement than other charities as we saw in the *Tel-Aviv Foundation* case. Failure to comply with the compliance agreement will make it far more likely that the charity’s registration will be revoked. Compliance agreements are discussed and negotiated with the Charity rather than proposed unilaterally by the CRA. CRA expects its auditors to include in the compliance agreement actions and timelines that can reasonably be accomplished by the charity. Within this process the charity always has an opportunity to provide additional representations or challenge CRA findings or negotiate with CRA on the compliance agreement.

### **Penalties and Sanctions**

5. In cases that are more serious, certain sanctions may be used, including suspension of the charity’s tax receipting privileges and financial penalties. As discussed above, it is more likely that the sanctions will be used now that they are available to CRA. For a list of Penalties see

CRA's website at <http://www.cra-arc.gc.ca/tx/chrts/plcy/csp/pnltseng.html> Also there is the Guidelines for Applying the New Sanctions which discusses CRA's view on the sanctions and it is located at <http://www.cra-arc.gc.ca/tx/chrts/plcy/nwsnctns-eng.html>. In serious cases of non-compliance the CRA may not use an educational approach and may move directly to either sanctions or revocation. To understand when something is "serious" the Guidelines provide as follows:

Serious cases of non-compliance include those where:

- the non-compliance reaches certain thresholds (either in absolute terms, such as the dollar value of expenditures on non-charitable activities, or relatively, such as the percentage of expenditures devoted to non-charitable activities);
- the non-compliance involves breaches of the *Criminal Code* (such as fraud or hate crime) or other quasi-criminal statutes;
- the non-compliance involves breaches of the core requirements of the *Income Tax Act* (such as the requirement that an organization be established for exclusively charitable purposes, as compared to a less central provision, such as that requiring charities designated as charitable organizations to concentrate on operating their own programs, rather than funding other charities); or
- the organization is not abiding by the terms of a compliance agreement.

In cases of **aggravated** non-compliance, we will likely move directly to revoking the charity's registration. These include cases where one or more of the following factors are present:

- the organization has a previous record of serious non-compliance, and the current form of non-compliance is both serious and intentional;
- the non-compliance has resulted in a substantial adverse impact on others (beneficiaries, donors, or funders), particularly where the organization cannot or will not remedy the harm done; and
- the organization cannot or will not bring itself into compliance.

It is understandable that the CRA will be rarely sympathetic to first time non-compliance when the dust settles, millions in tax receipts have been issued and no money has gone to charitable works or the charity has been uncooperative in the audit.

### **Revocation of Registration (6.5% of charities audited)**

6. Only in cases of serious non-compliance or unwillingness on the part of a charity to bring itself into compliance will there be a revocation of registration. If CRA decides to revoke the registration of a Canadian charity they will issue a Notice of Intention to Revoke to the charity by registered mail which indicates that CRA is beginning proceedings to revoke the charity's registration. A charity can object to CRA's internal Appeals Branch, appeal to the Federal Court of Appeal, or appeal to the Tax Court of Canada depending on the situation.

### **Other Outcomes (5% of charities audited)**

7. Other outcomes CRA advises include "voluntary revocations, annulments, pre-registration audits, Part V tax audits."

One of the key determinants of the results of an audit are the attitude of the charity and the willingness of a charity to make changes. An audit may encounter minor non-compliance with regard to some of the trickier or more obscure rules in the Act or it may encounter non-compliance fundamental to the operation of the organization. Some of the more serious non-compliance includes operating an unrelated businesses, non-charitable programs, or salaries/expenditures which are, in the view of the CRA, completely inappropriate. The difference between a Compliance Agreement and Revocation is often a willingness to make changes to the organization but may require a fundamental change to the way the charity operates to become compliant.

Some have criticized CRA for revoking the charitable status of too many charities. I think a good argument could be made that CRA should move more quickly to deregister a few of the really bad charities. By really bad, I mean that they are abusive charitable tax schemes involved with tens or hundreds of millions of dollars in receipts and provide little or no public benefit. However, that is another article. Few charities are revoked for cause and most charities that lose their charitable registration are revoked for non-filing of their T3010.<sup>5</sup> If and when CRA comes calling to audit your charity, hopefully some of the discussion above will be useful in minimizing any anxiety and maximizing the chance of a successful outcome.

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<sup>5</sup> As 80-90% of charities lose their registered charity status for failure to file the T3010 Registered Charity Information Return in a timely fashion, you may wish to review my article

[http://www.globalphilanthropy.ca/images/uploads/Canadian\\_Charities\\_-\\_File\\_your\\_T3010\\_on\\_time.pdf](http://www.globalphilanthropy.ca/images/uploads/Canadian_Charities_-_File_your_T3010_on_time.pdf) .

*Mark Blumberg is a lawyer at Blumberg Segal LLP in Toronto, Ontario. If you require legal advice or assistance he can be contacted at [mark@blumbergs.ca](mailto:mark@blumbergs.ca) or at 416-361-1982 x. 237. To find out more about legal services that Blumbergs provides to Canadian charities and non-profits please visit the Blumbergs' Non-Profit and Charities page at [www.blumbergs.ca/non\\_profit.php](http://www.blumbergs.ca/non_profit.php) or [www.globalphilanthropy.ca](http://www.globalphilanthropy.ca)*

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