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NOT FOR
PROFIT
ALERT

Federal Budget **IMPACT ON CHARITIES**

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The recent Federal Budget (“the Budget”) released in March 2010, made significant changes to the requirements for charities to spend their funds in a manner such that their charitable status will not be revoked by the Canada Revenue Agency (“CRA”). The proposed changes will apply to all registered charities for taxation years ending after March 3, 2010. The changes eliminate much of the complexity in complying with the rules in the Income Tax Act (“the Act”), which will be a welcome relief to many charities but, on the other hand, complexity is replaced with uncertainty as CRA will be administering the charitable status based on much broader rules and their administrative positions. Many of the proposals are consistent with the Concept Paper submitted to the Department of Finance by the National Charities and Not-For-Profit Law Section of the Canadian Bar Association.

Disbursement Quota

The most pronounced change addressed in the Budget was the proposal to effectively dismantle the disbursement quota (“DQ”).

Among other things, the existing legislation allows the CRA to revoke a charity’s registration if it does not meet the minimum requirements of the DQ. Under the DQ rules registered charities are required to spend each year on charitable activities (including gifts to other charities), a minimum of 80% of the prior year’s receipted donations plus other amounts relating to enduring property and transfers between charities. The Budget proposes that this portion of the DQ, referred to as the “charitable expenditure rule”, be eliminated, thereby, at the same time, eliminating concepts of terms such as “enduring property”, “specified gifts” and “capital gains pool” which are income tax terms only relevant for determining the “charitable expenditure rule.”

The reason stated for eliminating the “charitable expenditure” rule is that it is viewed as a hardship for smaller charities. Larger charities who receive

government grants and which earn income from businesses that they carry on, have a much easier time meeting the expenditure rule as these revenue sources are not included in the calculation of the “charitable expenditures rule” while the funds are available to meet the expenditure requirement.

The only portion of the DQ which has survived is what is referred to as “the capital accumulation rule.” This rule requires charities to spend on charitable activities in each year (above and beyond the “expenditure rule”) 3.5% of the fair market value of their total investment assets in excess of a base amount. The value for purposes of this calculation is the average fair market value of the charity’s assets that are not used directly in its charitable activities or administration in the 24 months immediately preceding the taxation year.

Prior to the Budget the 3.5% was applied to the value of the investment assets in excess of \$25,000. While the threshold for public foundations remains at \$25,000, the Budget proposes to increase it to \$100,000 for charitable organizations, thereby

further reducing the compliance burden of smaller charities and providing them with greater ability to deal with contingencies.

Administration of Charitable Spending

Notwithstanding the dismantling of the DQ, charities are not free to spend the money they raise at their discretion after they meet the minimum required under the substantially altered DQ. Charitable foundations and organizations are still, by definition, required under the Act to be “devoted exclusively to charitable activities.” In this regard, keep in mind that the old and new DQ is a minimum standard that, if not complied with, gives the CRA the authority to revoke charitable status. However, a charity could have and continue to meet the DQ and still have its charitable status revoked if CRA does not feel it meets the broader requirements in the Act which have survived the Budget.

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CRA has recently published “Fundraising by Registered Charities,” which provides their guidelines on acceptable fundraising activities. In addition, CRA has announced that they will develop further guidance to assist registered charities in understanding and complying with the reformed DQ and other income tax rules regarding expenditures. The guidelines and interpretation by CRA are not law but effectively will need to be complied with. CRA has stated that the development of these guidelines will include consultation with the charitable sector.

The Budget also proposes to broaden certain anti-avoidance rules preventing charities from meeting spending requirements through the transfer of funds between non-arm’s length charities and situations where transactions are undertaken to delay or avoid the application of the DQ.

As a result of the Budget proposals, the burden of complying with complex and in many cases onerous rules will be replaced by what for now will be a less understood set of criteria set by CRA. The rules that have survived are very broad in scope making it difficult to argue varying points of view. For example, how will CRA interpret the term “devoted entirely to charitable activities?” Hopefully, by including the charitable sector in the determination of the guidelines, what will follow is a simpler system which is well understood which will allow registered charities to pursue their charitable activities in a manner and spirit consistent with tax policy. §

Not-For-Profit ACCOUNTING RULES

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Accounting standards for NPOs were issued in 1996 and have for the most part remained unchanged since then. The not-for-profit Organizations Advisory Committee (“AdCom”) has been in deliberations since 2003 relating to updates to these standards.

In January 2009 the Accounting Standards Board of Canada (“AcSB”) issued a number of new rules or amendments to old rules, affecting financial statement year’s beginning on or after January 1, 2009.

We present a summary of 3 key changes which we feel will affect the majority of our not-for-profit (“NPO”) clients.

Section 4470 – Disclosure of allocated expenses by not-for-profit organizations

Many NPO’s, particularly charities, report expenses by the function to which those costs relate. Examples include Administrative, Fundraising, and Research. It is common for NPO’s to allocate administrative or fundraising expenses to a number of different departments. For example, the research function benefits from the usage of office space to conduct their affairs. As a result, a portion of rent expense will be classified under “research” in the financial statements.

In order to provide the users of the financial statements of an NPO with more relevant information, the AcSB issued Section 4470 – “Disclosure of allocated expenses by not-for-profit organizations.” Under this section, NPOs are

required to disclose the following information relating to the allocations of Fundraising and General Support costs:

1. The accounting policy disclosure should explain the policies adopted for the allocation of expenses among functions, the nature of the expenses being allocated and the basis on which such allocations have been made.
2. The amounts allocated from “Fundraising” and/or “Operating and Administration (General Support Costs)”, and the amounts and the functions to which they have been allocated, should be disclosed.

It is important to note that section 4470 does not require an NPO to allocate fundraising and general & administration expenses, but if an organization does allocate such expenses they must simply disclose the basis for the allocation.

Presentation of revenues and expenses

A new paragraph to section 4400 – Financial Statement Presentation has been issued. Paragraph 4400.37 states:

Revenues and expenses should be recognized and presented at their gross amounts when an organization is acting as a principal in transactions.

Previously, NPO’s tended to disclose revenues of fundraising events (i.e. golf tournaments) in the financial statements net of direct expenses. With the new guidance

only NPO's acting as an agent to the transactions can continue to disclose an event on a net basis, while principals are required to disclose revenues and expenses on a gross basis.

When trying to determine whether or not an NPO is an "agent" or a "principal", management must determine what level of risk the organization is taking in the enterprise, or what level of control does the NPO have.

Internally restricted assets

As with the original guidance, externally restricted resources can be presented either as deferred contributions or as part of net assets, depending on the organization's policies for accounting for contributions. The new guidance requires additional disclosures to identify net assets subject to internal restrictions and external restrictions (deferral method) or the amounts of net assets (or fund balances) attributable to each major category of internal restrictions and external restrictions (restricted fund method).

In conjunction with this additional disclosure is the elimination of the requirement to disclose net assets invested in capital assets as a separate component in the statement of financial position. NPO's now have the option to present the net assets invested in capital assets as a category of internally restricted net assets. When an organization segregates the amount of net assets invested in capital assets, the organization may either present the amount as a component of net assets in the statement of financial position or disclose the amount in a note to the financial statements. §

Future of Financial REPORTING FOR NPO'S

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"An entity, normally without transferable ownership interests, organized and operated exclusively for social, educational, professional, religious, health, charitable or any other not-for-profit purpose. A not-for-profit organization's members, contributors and other resource providers do not, in such capacity, receive any financial return directly from the organization." – *CICA Handbook 2010, Definition of a Not-for-Profit Organization.*

In its Strategic Plan, issued in January 2006, the CICA noted that "one size does not necessarily fit all" and decided to pursue separate strategies for publicly accountable profit-oriented enterprises, private profit-oriented enterprises, and not-for-profit organizations. The result has led to the introduction of International Financial Reporting Standards ("IFRS") for publically accountable entities and Accounting Standards for Private Enterprises ("ASPE") for private entities. Of continuing discussion is where NPOs fit into the new frameworks presented.

Under the current structure, NPOs report primarily under Section 4400 series of the CICA Handbook. They also fall under the general framework for profit oriented entities, unless a particular standard is superseded by Section 4400 (for example, exemption from capitalization of capital

assets under specific scenarios).

Historically, NPOs have shifted between being considered as publically accountable entities or not. Application of certain standards (and the subsequent reversal) of items like financial instruments indicated that NPOs cannot simply be grouped into predetermined categories such as public or private. Given the diversity of NPOs, in both size and structure, the CICA agreed with stakeholders "that options were required and that the choice between the options should be one that an organization can make freely."

Accordingly, an NPO can choose to apply IFRS or continue to apply the existing Section 4400 rules and the remaining existing framework. The decision to provide an IFRS option was made early on, so those NPOs, particularly those with international operations, had the ability to begin their transition process early. A drawback to adopting IFRS was a lack of specific standards on NPOs similar to those that exist in Section 4400.

In March 2010, the CICA exposed for comment its proposal to continue to use Section 4400 series. It should be noted that once these rules are adopted into the CICA

Handbook, the underlying framework of Section 4400 will be the ASPE. One of the comments requested from stakeholders is whether the underlying platform should continue to be based on the profit oriented entity framework, being the ASPE.

The standards will be adopted in their current form without modification; however, the CICA will in the near future be looking to improve these standards.

While these standards effectively remain the same, they are considered a change in the primary basis of GAAP – as such, the CICA has introduced an adoption standard, Section 1501, First-time Adoption by Not-for-Profit Organizations which contain certain transition rules. The transition date has been set for years beginning January 1, 2012, with early adoption possible.

Please watch for future releases of our NPO Financial Reporting Series as we bring you additional information on changes including detailed guidance on Section 1501, First Time Adoption by Non-Profit Organizations. A copy of the exposure draft is found at <http://www.acsbcanada.org/documents-for-comment/item35455.pdf>.

The CICA is actively seeking comments on the future of financial reporting for NPOs and has opened up the comment period to July 15th, 2010. §

Are you ready?

HST IS ALMOST HERE

Much has been written about the HST that was announced in the March 26, 2009 Ontario Budget. The tax will be effective July 1, 2010. It will be combined with the federal GST to create a 13% federally administered single harmonized sales tax. The Ontario portion of the tax will replace the existing Ontario retail sales tax.

The HST will substantially follow the GST regime, with a few special rules for charities and not-for-profit entities. For more details, please refer to an article located on the Collins Barrow website - Ontario Harmonized Sales Tax (HST) – Public Service Bodies Article, published in 2010. <http://www.collinsbarrow.com/link.asp?u=HST>. §

Collins Barrow publishes a quarterly NPO Newsletter for its clients and associates. While the NPO Newsletter suggests general planning ideas and technical updates, we recommend professional advice always be sought before taking specific planning steps.

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