A state of change

Introduction
The Canada Revenue Agency (CRA) is increasingly becoming more aggressive in auditing businesses and Not-for-Profit Organizations (NPOs). In response to this, we provide you in this issue with guidance and clarity on two particular areas where the CRA is focusing their efforts – common payroll errors; and claiming the tax-exempt status. We also provide online access to our recently issued updated publications on governance leading practices for NPOs to assist Boards of Directors to better understand and improve their effectiveness.

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Common payroll errors – Are you affected?

It’s that time of year again when payrolls are being closed and year-end reporting is on the horizon. This can be a stressful time for payroll practitioners. Errors can arise, which can require a significant amount of time to resolve, with an associated administrative burden. With this in mind, it pays to be proactive. The following is a list of the common payroll errors that you should try to avoid:

**Not reporting payments for services provided by an independent contractor**

Whereas employees receive T4 forms at the end of the year, payments made to independent (i.e. self-employed) contractors for services provided should be reported on a T4A form. The latter requirement is often missed, but can be a relatively quick and easy fix so long as the invoices from the independent contractor are tracked.

**Automobile benefits**

Where an employer provides its employees with a motor vehicle, the personal usage of the vehicle gives rise to a taxable benefit to the employee. The process of establishing the benefit can be a little cumbersome, with automobile standby charges and operating expenses requiring calculation. There may be cases where employees do not maintain proper records to separate personal and business driving, which can lead to incorrect calculation of the taxable benefit. Accordingly, a process for employees to accurately track their personal use is key.

There is an incorrect perception that if a vehicle does not meet the CRA definition of an automobile, no benefit is reported. This is not the case. If required, an employer must reasonably estimate the fair market value of the personal use of the motor vehicle.

**Personal and living expenses**

Some employees, as part of their compensation package, may have personal living expenses paid for by the employer. The default position is that employer payment of these expenses would be considered taxable income. Therefore, unless these expenses fall under a specific exemption, it is important to track, and review the specific nature of, such expenses.

**Salary expenses**

One would imagine that salary expenses would be at the core of any payroll, but a common error arises from unreported salary and wages, as well as bonuses and other cash payments. This is often seen in practice in “split” payroll or “shadow” payroll cases, which arise for employees seconded to Canada by their overseas employers, whereby they continue to be paid in part by the non-Canadian employer. In such cases, a Canadian payroll would not deliver full pay to the employees – rather the primary function would be to account for appropriate withholdings and accurate reporting from a Canadian perspective.
Vehicle allowance

Unlike the automobile benefits discussed above, another common practice is for employers to provide round sum vehicle allowances to employees. These are for all intents and purposes regarded as additional cash compensation and should be treated in the same manner as salary income. However, it is a common error to inadvertently exclude such allowances from taxable income.

Classification of employment status

Always a hot topic for the CRA, the use of contractors as detailed above is widespread and of course entirely legitimate, but whether an individual is genuinely a self-employed contractor depends on the specific facts and circumstances. The CRA has identified cases where an organization had felt that there was a “contract of service – business relationship,” in place, whereas an analysis of the facts concluded that the arrangement was more consistent with a “contract for services – employer-employee relationship.” The facts of the case must always be reviewed, but if unsure, a proactive ruling can always be sought from the CRA.

Employee parking

All too often employers neglect to report the value of this benefit, and when an amount is reported, it is a minimum amount and not the true market value. Employer-provided parking is usually a taxable benefit for an employee regardless of whether the employer owns the lot, although there are exceptions in cases of disability, business purposes and “scramble” parking. The CRA also does not expect a benefit to be calculated if a business operates from a shopping centre or industrial park where parking is available free of charge to employees and other people.

Housing benefits

In cases where an employee is provided free or subsidized housing, there is generally a taxable benefit to the employee. This would be the amount of rent paid by the employer (less any contributions made by the employee). This is ordinarily accounted for correctly through payroll, but the errors typically arise in cases where the property is owned by the employer and no actual rent payments are made by the employer. In such instances, the taxable benefit would be the fair market value rent that would be payable by a third party for equivalent accommodation (again less any contributions made by the employee). Note that it may be possible for there to be no taxable benefit if the “special work site” rules are in play, in which case a form TD4 signed by the employee should be held on file.

Reporting taxable benefits only at the end of the year

The value of benefits provided to employees should be included as income when received or enjoyed. There can be a tendency by employers to only account for non-cash benefits through the payroll on an annual basis; however, if a benefit is provided/paid through the year (say on a monthly basis), the value of the benefit should be prorated, and included as income on a per pay basis.
In addition to the common pitfalls above, an employer who frequently makes late remittances, or has large over or under payments may trigger an audit by the CRA.

The best practice is to perform a payroll self-audit on a regular basis (perhaps quarterly), to prevent the common errors, and correct the errors on a timely basis. This proactive approach will ultimately minimize the cost (and related administrative burden) to you should the CRA audit your payroll.
The Canadian income tax legislation provides Not-for-Profit Organizations ("NPOs") with an exemption from income tax provided that they meet all of the criteria set out in the Income Tax Act (the "Act").

NPOs generally include entities such as service clubs, golf and tennis clubs, various associations and societies (other than charities). However, the creation of an entity as an NPO under provincial or federal not-for-profit legislation does not automatically entitle the organization to the exemption from taxation under the Act. The criteria contained in the provincial and federal not-for-profit legislation for the purposes of an organization’s incorporation are not the same as the criteria required to qualify for tax exemption under the Act.

In order to qualify for tax-exempt status pursuant to paragraph 149(1)(l) of the Act, all of the following conditions must be met by an NPO:

- it is not a charity;
- it is organized and operated exclusively for social welfare, civic improvement, pleasure or recreation or for any other purpose except profit;
- no income can be paid to, or made available for the personal benefit of, any proprietor, member or shareholder of the NPO (exception to this rule is available in a situation where the proprietor, member or shareholder was a club, society or association the primary purpose and function of which was the promotion of amateur athletics in Canada).

This income tax exemption has changed little since it was originally introduced in the Income War Tax Act in 1917. The types of organizations that are currently claiming the exemption has changed over the years, and the number of organizations claiming the exemption has increased substantially. The CRA estimates that there may be more than 80,000 NPOs claiming the exemption.

Unlike charities, NPOs are not required to register with the CRA to confirm their tax-exempt status. In technical interpretation No. 2010-0366051E5, the CRA indicates that the determination of whether an NPO is tax-exempt is a question of fact that could only be determined after a detailed review of the organization’s documents, and all underlying activities to ascertain its purposes and intentions after the organization has been established and in operation during the year in question. This is a determination that can only be made after the fact, thus the CRA will not provide advance income tax rulings to confirm the tax-exempt status of an NPO in advance. Furthermore, NPO’s have historically not had the same level of scrutiny by the CRA as registered charities. For example, NPO’s that are not incorporated may not have a filing requirement, and those that are required to file are only required to provide minimal information. Until only recently, the CRA has had minimal audit activity with respect to NPOs. As a result, NPOs can operate for years without any confirmation of their tax-exempt status.
In 2009, the CRA identified 30,000 entities that are currently claiming this tax exempt status and undertook an audit project using a sampling of these entities.

During the audit project, the CRA reviewed the sample organizations with reference to four key requirements set out in the Act:

- the organization is not a charity;
- the organization is organized exclusively for social welfare, civic improvement, pleasure, recreation, or any other purpose except profit;
- the organization is operated exclusively for social welfare, civic improvement, pleasure, recreation, or any other purpose except profit; and
- the organization’s income is not payable to or made available for the personal benefit of a member, proprietor, or shareholder.

Upon completion of the audit project, CRA indicated that its findings were as follows:

- a small number of NPOs were found to be a charity, and therefore would not qualify as an NPO;
- a small number of NPOs were identified whose governing documents (such as articles of incorporation, letters patent, etc.) indicated that they were not organized exclusively for a purpose other than profit;
- a significant number of NPOs were identified that were not operating exclusively for a purpose other than profit;
- a small number of NPOs were identified that had income payable to, or otherwise made available for the personal benefit of, a proprietor, member or shareholder.

In 2009, the CRA identified 30,000 entities that are currently claiming this tax exempt status and undertook an audit project using a sampling of these entities.
The CRA concluded that:

“The results from the review of the randomly-selected organizations suggest that a significant portion of incorporated organizations would fail to meet at least one of the requirements set out in paragraph 149(1)(l) of the Act. Of these:

• A significant portion would fall into a higher category of risk, which includes organizations earning profits that were not incidental or not related to their non-profit objectives; organizations with disproportionately large reserves, surpluses, or retained earnings; and organizations where income is payable or made available for the personal benefit of a proprietor, member, or shareholder. Many of the organizations that fall within this higher-risk category would not actually qualify for the tax exemption under paragraph 149(1)(l) of the Act and would need to be reassessed if they were audited outside the purview of the Non-Profit Organization Risk Identification Project (“NPORIP”), which would in most cases result in an increased tax liability to the organization.

• A small portion would fall into a lower category of risk, which includes readily correctible issues, such as making filing errors or not providing enough information to substantiate a not-for-profit purpose in the organization’s governing documents.

It should be noted that it is the CRA’s position that an NPO can earn profits, but the profits should be incidental and arise from activities that are undertaken to meet the organization’s non-profit objectives. The earning of profit cannot be or become a purpose of the organization, even if the profit is earned to fund non-profit objectives. This is contradictory to the belief of many NPOs that it can produce a profit to fund the organization’s non-profit purpose.

Based on its review, the CRA recognizes that education and outreach with the non-profit sector are critical to improving many organizations’ compliance with paragraph 149(1)(l) of the Act. Accordingly, it will work with representatives of the non-profit sector to determine how the sector’s knowledge of the income tax rules can be improved. The CRA will also look to improve NPOs’ understanding of their income tax obligations through targeted outreach activities, client service, and education. As part of this work, the CRA will review, revise, and improve as required the educational materials and support it provides in this regard. Finally, because the review also reveals that the legislative framework may benefit from further examination, a copy of this report will be provided to the Department of Finance Canada for information and consideration.”

As a result of the submission to the Department of Finance, Budget 2014 announced the Government’s intention to “review whether the income tax exemption for NPOs remains properly targeted and whether sufficient transparency and accountability provisions are in place.” This review will not extend to registered charities or registered Canadian amateur athletic associations which operate under greater filing obligations and scrutiny. As part of the review, the Government will release a consultation paper for comment and will further consult with stakeholders as appropriate.

At this time, things seem to be on hold until the Department of Finance provides further guidance and clarification with respect to the rules. However, the CRA may continue to act based on their current policies. As such, NPOs should review the CRA’s NPO policies, and ensure they are in compliance with them.

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Governance leading practices for Not-for-Profit Organizations

Not-for-Profit Organizations ("NPOs") play an important role in our society, delivering a wide range of services across a variety of different industries. Although they often face the same or similar challenges as profit oriented entities, they must address other issues that are unique to NPOs. At times, they may even find themselves in direct competition with profit oriented entities, such as recruiting top talent with the skills and expertise to enable them to achieve their mission.

The NPO regulatory environment has been rapidly evolving in recent years, with the introduction of the new federal Not-for-profit Corporations Act, the Personal Information Protection and Electronic Documents Act, and Canada’s Anti-Spam Legislation. In light of these changes, some NPOs may need to revise their strategies, while others may choose to do so in order to take advantage of new technologies, such as social media, to better communicate with stakeholders and build community support among other things.

To address these wide-ranging issues, Deloitte has issued two publications to help Boards of Directors of NPOs ("Boards") better understand their evolving operating landscape, improve their effectiveness in the governance role, and transform these challenges into opportunities by promoting informed discussions with management.

The first publication, “Lead or be led: Time to take advantage of the new business reality,” provides Boards with a selection of key issues facing NPOs today, as well as suggested questions for Boards to ask to help focus the discussion on the needs of their own organizations.

The second publication, “The effective not-for-profit board,” has been updated to help readers better understand their responsibilities as NPO board members. This publication focuses on the relevance of good governance to NPOs, emerging best practices, and challenges specific to NPOs. It also outlines the Deloitte Governance Framework which can be employed to provide structure to Boards in setting and executing their governance strategy.

The two publications can be accessed online through Deloitte’s Centre for Corporate Governance, using the hyperlinks below. To obtain copies of these documents offline, please contact your local Deloitte representative or any of the key contacts listed in this newsletter.

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- The effective not-for-profit board
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