

FREQUENCY OF VARIOUS TYPES OF NON-COMPLIANCE BY REGISTERED CHARITIES

At its September 2001 meeting, the Joint Regulatory Table asked for information regarding the types of non-compliance charities engage in, and how frequently these problems arise. It was felt that such information was necessary in developing proposals for a reformed compliance regime for registered charities.

Direct information of the type requested by the Table is unobtainable. What can be observed are the problems found by existing regulatory authorities when they investigate charities. It is impossible to say whether these problems are representative. Indeed, there is a strong possibility they are not, given that a regulator may be concentrating on a particular type of non-compliance at any given time.

In an effort to balance out some of the biases, three separate sets of data were examined:

- the 58 occasions on which the CCRA's Charities Directorate revoked a charity's registration, for reasons other than non-filing of the annual return, between 1995 and 2001 inclusive;
- the 545 files handled by the Compliance Division of the Charities Directorate in the first six months of 2000; and
- the 116 inquiries held by the Charity Commission for England and Wales, which had been reported on the Commission's web-site by November 2001.

The data gathering and analysis were carried out by the Table's secretariat.¹

1. General

Table 1 shows the most frequently occurring types of non-compliance in each of the three data sets. Items marked with a check mark—✓—are those of concern to both the Canadian and U.K. regulator. Those with a bracketed check mark—(✓)—represent partially overlapping areas.

¹ Researchers were Diana Laing, John Skelton, and Judy Torrance.

Table 1**Five Most Frequently Reported Types of Non-Compliance**

Rank in frequency	CCRA Compliance Division files	CCRA revoked organizations*	Charity Commission
I	Inaccurate tax receipts	Inaccurate tax receipts	(✓) Financial controls weak
II	✓ Filing deficiency (inaccurate, late, missing)	✓ Filing deficiency (inaccurate, late, missing)	(✓) Remuneration of directors, other benefits
III	✓ Books and records inadequate	✓ Non-charitable activities	✓ Filing deficiency, inaccuracy
IV	Other <i>Income Tax Act</i> concerns (e.g. issuing T4s)	✓ Books and records inadequate	Trustees failure of duty of prudence
V	✓ Non-charitable activities	Cannot meet disbursement quota	<ul style="list-style-type: none"> ▪ Trustees failure of duty of care ▪ Governance issues (equal fifth in rank)

* Does not include organizations that were revoked solely for failure to file their return.

The data suggests:

- An organization that has attracted the regulator's attention is usually experiencing several problems. On average the Compliance Division files had 2.5 problems per file, the revoked organizations 3.0 problems, and organizations subject to a Charity Commission inquiry 2.8 problems.
- Filing deficiencies are a leading source of non-compliance in all three data sets.
- The two Canadian data sets rank non-charitable activities somewhat higher than the Charity Commission's equivalent category ("assets used for non-charitable purpose"), but this type of non-compliance was reported in 17% of the Charity Commission inquiries.
- Inadequate books and records was a type of non-compliance that was highly ranked on both Canadian data sets. Among the Charity Commission inquiries,

this type of non-compliance only emerged moderately frequently. Perhaps the *Income Tax Act*'s explicit requirements on keeping proper books and records may explain the greater frequency this type of non-compliance was observed in Canada.

- Another interesting figure is that 5% of both the revoked organizations and those subject to a Charity Commission inquiry fall into a category that essentially represents fund-raising scams.
- However, the different legal framework in the two countries is apparent, with the CCRA much more focused on the provisions of the *Income Tax Act*, and the Charity Commission emphasizing issues of governance and proper trustee leadership.

2. Files handled in CCRA's Compliance Division, January-June 2000

Between January and June inclusive, 2000, the Compliance Division of the CCRA's Charities Directorate reviewed the files of 545 charities, most of which had been subject to a field audit. The researchers were unable to examine 34 of these files, despite at least two attempts to locate them.² Thus, this data set contains information derived from a study of 511 files.

Audits were conducted for various reasons. For the 399 files on which the reason for conducting an audit could be identified, the most common reason was to follow-up on a previous audit (29%). Internal leads, generated either from a review of the annual return or by work on another organization's file, accounted for a further 27% of the audits. Less frequent reasons were: because Compliance Division was focussing on a particular topic (21%); a lead from the general public (12%); random selection (10%); and as a follow-up to concerns raised at the time the charity was registered (1%).

Table 2 shows the distribution of the various types of non-compliance that emerged.

² There were various reasons why a file might not be accessible. For example, it might be out in the field with an auditor for a follow-up audit; it might be on loan to another part of the CCRA; or it might simply be mis-shelved.

Table 2

Compliance Division Files: Types of Non-Compliance

Type of non-compliance	Number of times this type of non-compliance found	% of the 511 charities with this type of non-compliance
Non-charitable purposes	18	4
Non-charitable activities	77	15
More than incidental and ancillary political activities	12	2
Unrelated business activities	7	1
Benefits improperly conferred on individuals	16	3
Books and records inadequate	158	31
Failure to meet disbursement quota	26	5
Gifts to non-qualified donees	56	11
Lack of control over foreign activities	41	8
Issuing tax receipts improperly	372	73
Filing an inaccurate/incomplete return	289	57
Filing a return late or not filing	81	16
Other <i>Income Tax Act</i> concerns	105	21
Total (Average number of types of non-compliance found per charity = 2.5)	1258	

The categories of non-compliance are based on those developed by the Compliance Division for its own purposes. Some categories may not be familiar to outside readers:

Failure to meet disbursement quota: The *Income Tax Act* requires registered charities to spend a certain minimum amount each year on their charitable programs. A charity that has not spent this minimum amount is said to have “failed to meet its disbursement quota.” Large expenditures on, for example, fund-raising may be the reason why the charity cannot meet its quota.

Gift to non-qualified donee: Under the scheme of the *Income Tax Act*, registered charities can only make gifts to other organizations, if these organizations are “qualified donees.” Registered charities comprise the single largest category of qualified donees, but the *Act* lists a number of other categories, such as municipalities and certain foreign universities.

Lack of control over foreign activities: Charities delivering charitable services outside Canada are expected to retain direction and control over these programs. Organizations are not considered to be controlling their own activities when they simply transfer funds to support the work of a foreign organization.

Issuing tax receipts improperly: This category covers both substantive problems, for example, when official donation receipts are issued for amounts substantially above the value of the gift received, and minor problems, for example, dealing with the format of these receipts. Unfortunately, this data set did not differentiate the substantive from the minor problems.

Other *Income Tax Act* concerns: This category covers a diverse range of provisions in the *Income Tax Act*, including provisions that apply to all organizations, such as issuing proper records of the income earned by their employees (T4s).

About 10 years ago the Directorate produced a comparable table showing the types of non-compliance emerging from audits.³ The results are reproduced in Table 3 below. Comparing this earlier data set with the 2000 results would suggest that the distribution of the various types of non-compliance has not changed greatly over this time period.

Table 3

Compliance Division Files: Types of non-compliance, early 1990s and 2000
(vertical percentages)

Types of non-compliance	Early 1990s	2000
Non-charitable purposes and activities	2.1	7.6
More than incidental and ancillary political activities	0.7	1.0
Unrelated business activities	0.5	0.6
Benefits improperly conferred on individuals	1.1	1.3
Books and records inadequate	5.9	12.6
Failure to meet disbursement quota	2.9	2.1
Gifts to non-qualified donees	2.3	4.5
Lack of control over foreign activities	3.0	3.3
Issuing tax receipts improperly	34.9	30.0
Filing an inaccurate/incomplete return	27.1	23.0
Filing a return late or not filing	1.6	6.4

³ The actual study on which the early 1990s figures are based could not be located. The figures were apparently derived from a database kept at that time of the types of non-compliance recorded in 1424 audit reports. The categories of non-compliance appear to be virtually identical to those used in the later study, although it was necessary to collapse some categories to make them comparable.

Other	17.9	8.3
Total	100 N = 1755	100 N = 1258

When reviewing an audit, Compliance Division has a number of options open to it. These are:

- Issue a “clean letter”: no significant areas of non-compliance were found.
- Issue an “educational letter”: one or more areas of non-compliance were found, and the charity is advised what needs to be done to comply with the legal requirements.
- Issue an “undertaking letter”: one or more serious areas of non-compliance were found, and the charity is required to provide a written undertaking that it will address the problems observed.
- Issue an “administrative fairness letter”: one or more serious areas of non-compliance were found, and the charity is advised that the Directorate is considering either revoking or annulling the organization’s registration.
- Revoke the organization’s registration: Note that the number of revocations in the Table 4 below is higher than the number of revocations for serious offences (N = 14 for the entire year 2000) reported in the Table’s Interim Report. The larger number below includes charities that asked to be de-registered or that were de-registered for not filing their annual return during the period while the audit was under review by Compliance Division.
- Annul the organization’s registration: Registrations may be annulled when the Charities Directorate concludes it made an error in registering the organization in the first place. Annulments do not give rise to the tax faced by organizations with revoked registrations. The number of annulments in Table 4 is somewhat higher than the number (N = 13 for the entire year 2000) reported in the Table’s Interim Report. The difference may be due to recording the date of annulment differently in the two data sets.
- Cancel the audit: If the Compliance Division was unable to review audit results within a reasonable timeframe, a decision may be made to cancel the original audit and re-audit to obtain more up-to-date information.
- “Other:” This category covers non-audit related tasks the Compliance Division performed, such as calculating an organization’s disbursement quota.

Table 4**Compliance Division Files: Outcome of audits**

Action taken	Number	Percentage
Clean letter	21	4
Educational letter	162	32
Undertaking letter	204	40
Administrative fairness letter	8	2
Annulment	17	3
Revocation	57	11
Cancel the audit	28	5
Audit still ongoing	9	2
Other	5	1
Total	511	100

The above distribution suggests that roughly 1 in 10 files handled by the Compliance Division ends up in a revocation. However, 7 out of 10 files result in either undertaking letters or education letters.

Do the different types of audit outcomes vary by the types of non-compliance? If this proves to be the case, this would suggest that the Compliance Division typically treats some forms of non-compliance with greater severity than others. Table 5 looks only at education letters, undertaking letters, and a combined category of the three most severe responses (administrative fairness letter, annulment, and revocation).

Table 5**Compliance Division Files: Type of Non-Compliance by Outcome of Audit**

Type of non-compliance	Action taken by Compliance Division (percentages run horizontally)			Total (N) = 100%
	Education letter	Undertaking letter	AFL, annulment, revocation	
Non-charitable purposes	6%	12%	82%	(17)
Non-charitable activities	6	23	71	(70)
More than incidental and ancillary political activities	25	63	13	(8)
Unrelated business activities	17	17	67	(6)
Benefits improperly conferred on individuals	27	27	47	(15)
Books and records inadequate	21	57	21	(145)

Failure to meet disbursement quota	4	63	33	(24)
Gifts to non-qualified donees	21	62	17	(53)
Lack of control over foreign activities	16	62	21	(37)
Issuing tax receipts improperly	39	51	10	(346)
Filing an inaccurate/incomplete return	36	52	12	(267)
Filing a return late or not filing	20	43	37	(76)
Other Income Tax Act concerns	34	52	15	(95)
Total	29	50	21	(1159)

The table indicates that the types of non-compliance most likely to attract a severe response are: non-charitable purposes, non-charitable activities, unrelated business activities, and benefits improperly conferred on individuals. However, no type of non-compliance was consistently treated in either a lenient or a severe manner. This would suggest that the facts particular to each case strongly influence the outcome—facts such as whether one or several types of non-compliance are present and the degree of non-compliance.

(While outside the scope of the survey, the Directorate’s practice of de-registering organizations that do not file their annual return should not be forgotten. This practice represents an exception to the conclusion in the previous paragraph. Here, there is a particular type of non-compliance that has consistently been met with a severe response.)

Around a third of the Compliance Division files were charities that had been audited at least once before. The action taken on these files was not more severe in nature, but generally followed the same pattern as observed in the sample as a whole. Among the possible explanations for this pattern is that previously audited organizations do tend to correct their non-compliant actions, with the result that Clean or Educational letters are issued, or that if the same type of non-compliance is observed again, it is still not considered sufficiently serious to merit revocation.

3. CCRA’s Revocation Files

Forming the database are the files of all 58 organizations that had their registration revoked for reasons beyond a filing deficiency between 1995 and 2001, inclusive. The coding categories are those developed by the Charities Directorate’s Compliance Division for its own purposes.

Table 6**Revocation Files: Types of Non-Compliance**

Type of non-compliance	Number of times this type of non-compliance found	% of the 58 charities with this type of non-compliance
Non-charitable activities [and purposes]	29	50
More than incidental and ancillary political activities	9	16
Unrelated business activities	3	5
Benefits improperly conferred on individuals	7	12
Books and records inadequate	27	47
Failure to meet disbursement quota	13	22
Gifts to non-qualified donees	8	14
Issuing tax receipts improperly (includes 21 cases of substantive abuse and 15 cases where the format of the receipt was at fault)	36	62
Filing an inaccurate/incomplete return	15	26
Filing a return late or not filing	15	26
Lack of control over foreign activities	3	5
Loan backs	0	-
Non-qualified investments	0	-
Scholarships/awards	0	-
Not issuing T4/T4As	5	9
Director's loan	0	-
High fundraising/low program expenditures	9	16
Other	1	2
Total (Average number of types of non-compliance found per charity = 3.1)	180	

4. U.K. Charity Commission Inquiries

Table 7 presents results from a study of the Charity Commission's reports of its inquiries, posted on its web-site by November 2001. In terms of regulatory concerns, only about a third of the issues raised in the various Charity Commission reports appear similar to those identified by the CCRA. (We have no information on issues that Inland Revenue might raise with charities in England and Wales.)

Table 7

Charity Commission Inquiries: Types of Non-Compliance

Type of non-compliance	Number of times this type of non-compliance found	% of the 116 charities with this type of non-compliance
✓ = overlap with CCRA jurisdiction (✓) = partial overlap with CCRA jurisdiction		
✓ Assets used for non-charitable purpose (or can't be proved to have been so used)	20	17
Charitable activity not within scope of charity's objects	3	3
✓ Political activity	2	2
✓ High fundraising costs in relation to charitable activity	6	5
Charity inactive	8	7
Failure to comply with fund-raising legislation	15	13
Misrepresentation to public	10	9
✓ Financial controls weak	29	25
Failure to comply with SORP [U.K. standards for preparing financial statements]	10	9
✓ Poor records (e.g. minutes)	17	15
Administrative inefficiency, proper procedures not in place	18	16
(✓) Theft of charitable funds/fraud	2	2
Use of unauthorized name	4	3
✓ Filing deficiency, inaccuracy	26	22
(✓) Remuneration of directors, other benefits	26	22
Non-avoidance of potential conflict situations	20	17
Trustees to act collectively, no dominance by single trustee	7	6
Trustees to control staff/CEO	18	16
Failure of duty of prudence (didn't seek advice esp. re investments etc.)	25	22
Failure of duty of skill (lack knowledge)	8	7
Failure of duty of care (diligence, vigilance)	23	20
Governance (insufficient trustees, quorum, annual meeting, ineligible trustees)	23	20
Failure to comply with previous Commission advice/order	8	7
Total (Average number of acts of non-compliance found per charity = 2.8)	328	

The Charity Commission can remove an organization from the register of charities. (This is rather different from de-registration in Canada, which affects an organization's tax-status rather than its status as a charity.) As a result of the 116 inquiries, 20 charities (or 17%) were removed from the register.

5. Revocation of Tax-Exemption by the I.R.S. in the United States

A recent American report⁴ cites figures on the primary reason given by the Internal Revenue Service for revoking the tax-exempt status of charities. The numbers are presented below in Table 8. For various reasons, these American numbers are not readily comparable to those produced by the data sets discussed previously. However, they do show a remarkably low number of revocations in the United States, relative to the Canadian rate. This may be a reflection of the availability to the I.R.S. of alternative sanctions short of revocation.

Table 8

I.R.S. Revocations of Tax-Exemption: Primary Reason for Revocation

	1996	1997	1998	1999	2000	2001
Filing deficiency	1	1	1	-	-	-
Discontinued operations		-	2	-	1	-
Inadequate records	1	-	2	-	2	-
Inurements [private benefits]	6	5	2	1	1	1
Non-exempt activities	2	-	1	1	11	1
Operating in a commercial manner	1	-	1	1	-	-
"Met operational test"	3	3	3	1	2	-
"Private vs. public"	2	1	3	-	-	-
"Private use"	-	-	-	-	3	-
Others*	-	2	9	4	7	7
Total	16		24	8	27	9

* This category includes revocations for problems associated with political activities and unrelated business activities.

⁴ United States General Accounting Office, *Tax-Exempt Organizations: Improvements Possible in Public, IRS, and State Oversight of Charities* (April 2002, GAO-02-526), available on the GAO's web-site, www.gao.gov.