FINANCIAL PENALTIES ON DIRECTORS, OFFICERS, AND EMPLOYEES

Should financial penalties on individuals be included among the intermediate sanctions?

This paper attempts to provide background information the Table may find useful in considering this question.

Elsewhere in the *Income Tax Act*

The *Income Tax Act* already contains provisions that tax individuals for various forms of non-compliance. Subsection 188(2) is the only one in the charity context (it deals with individuals making an improper gain from a charity after the organization has lost its registration but while it is still subject to the revocation tax). The other two make a corporation's directors and others jointly responsible with the corporation, when the corporation commits an offence or when the corporation does not remit source deductions.

> 188(2)—during a charity's winding up period, a person receiving an amount from a charity subject to the revocation tax is liable for the amount he or she received, unless the amount represents a fair-market-value payment for goods and services he or she has rendered to the charity.
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> 242—where a corporation commits an offence under this Act, any officer, director or agent of the corporation who directed, authorized, assented to, acquiesced in or participated in the commission of the offence is party to and guilty of the offence and is liable on conviction to the punishment provided for the offence whether or not the corporation has been prosecuted or convicted.
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> 227.1(1)—where a corporation has failed to deduct or withhold an amount … [for source deductions], has failed to remit such an amount, or has failed to pay … [certain taxes], the directors of the corporation at the time the corporation was required to deduct, withhold, remit or pay the amount are jointly and severally liable, together with the corporation, to pay that amount and any interest or penalties relating thereto.

Practice in other countries

Countries vary in their approach depending on their historical traditions.

The United States is the only jurisdiction that has enacted several provisions imposing financial penalties on individuals connected to a charity. This is in the context of the federal *Internal*

*Revenue Code (*the U.S. equivalent of the *Income Tax Act*).[1]

In England and Wales, the Charity Commission has no direct authority to impose a financial penalty on individuals connected to a charity, nor does the tax legislation create such penalties.

Australian tax legislation also contains no such penalties.

In the United States (*Internal Revenue Code*)

The United States is the only jurisdiction that makes provision for a broad range of financial penalties on individuals connected to voluntary sector organizations. These are penalties applicable only in this context, rather than broader provisions that happen also to be applicable to the voluntary sector context.

The *IRC* penalizes, variously, the tax-exempt entity, its manager, employees, and other individuals.

Tax on excess benefit transactions

These are transactions where a "disqualified person" receives more from an organization than he or she gives in return. One example is a salary that is out of line with industry standards. Another would be the sale of organization property at below market rate.

A disqualified person is one in a position to exercise substantial influence over the organization's affairs. Some fall automatically into this category:

- voting members of the governing body;
- the President, COO, or CEO; and
- the Treasurer or Chief Financial Officer.

A person who founded or substantially contributed to the organization is assumed to exercise substantial influence, absent any contrary evidence. Others may be considered disqualified based on the facts-and-circumstances of a particular case.

Section 4958 of the *Code* imposes a penalty on the disqualified person of 25% of the amount of the excess benefit. This rises to 200% if the excess benefit is "not corrected" (i.e., paid back to the organization) within the same fiscal period in which the benefit was received).

An organization's manager, who participates in the transaction knowing it was improper, faces a penalty of the lesser of $10,000 or 10% of the excess benefit amount. A "manager" is defined as

[1] At the state level, only a handful of U.S. states have an active regulatory program. No information is currently available on whether any state levels financial penalties on individuals connected to a charity, although anecdotal evidence suggests the approach taken is more along the lines of traditional charity regulators, such as the Charity Commission in England and Wales (see below) and Ontario's Public Guardian and Trustee.

any officer, director or trustee of the organization, or person exercising similar powers or responsibilities.

Other Internal Revenue Code *financial penalties*

FORM OF NON-COMPLIANCE	WHO IS LIABLE?	TYPE
failure to provide a copy of a return to a member of the public	organization employee who refuses to provide the return	$20 a day
late or incomplete filing	organization, and individuals responsible for filing	$20 a day
inappropriate "political" activities and "lobbying"	organization, and managers who agreed to the expenditures	% of expenditures on these activities

In addition the U.S. has a number of penalties, based on a percentage of the amount involved, that apply only to private foundations. While some are payable only by the organization, others may be imposed on individuals connected to the organization:

- self-dealing (the individual concerned);
- undistributed income (organization);
- excess business holdings (organization);
- jeopardizing investments (organization and foundation manager who wilfully participated in the transaction);
- and expenditures on non-charitable purposes (organization and foundation manager who agreed to such expenditures).

<u>In England and Wales (*Charities Act 1993*)</u>

The legislation creates a series of <u>offences</u> (as distinct from administrative financial penalties). The Charity Commissioners are not involved in any resulting prosecutions. Any proceedings can only be commenced with the consent of the Director of Public Prosecutions. The offences generally target the "persons" responsible for the breach. In most cases, these will be the trustees or directors of a charity. Moreover, section 95 specifically provides that where any offence under the *Charities Act* is committed by a corporation, "with the consent or connivance of, or [is] … attributable to any neglect" by, a director, manager, secretary or similar officer, the individual is equally guilty with the corporation and is liable to be punished accordingly.

Examples of offences:

Section	Offence	Penalty
5(4)	Person issuing (or authorizing the issue of) certain documents not containing the statement that the organization is a registered charity	On summary conviction: fine not exceeding level 3 of standard scale

11(1)	Person knowingly or recklessly providing the Commissioners with false or misleading information	On summary conviction: a fine not exceeding the statutory maximum. On conviction on indictment: imprisonment for up to two years or fine or both.
18(14)	Person contravening an order, made during the course of an inquiry, restricting transactions involving charitable property	On summary conviction: fine not exceeding level 5 of standard scale
49	Person not filing annual report and return with Commission or providing a copy of financial statements on request to member of public	On summary conviction: fine not exceeding level 4 of standard scale
73(1)	Person acting as a charity trustee while disqualified (e.g., convicted of an offence involving dishonesty or deception, undischarged bankrupt; or previously removed from office as a charity trustee)	On summary conviction: a fine not exceeding the statutory maximum. On conviction on indictment: imprisonment for up to two years or fine or both.

The Charity Commission's main compliance weapon is the power to issue orders of various kinds. For example, it can order a person, who acts as a charity trustee while disqualified from doing so, to repay to the charity any remuneration or benefits received from the charity. (s. 73(4)) Disobedience of an order can, on application by the Commissioners to the High Court, be dealt with as disobedience to an order of the High Court. (s. 88)

The Commissioners do not have the power to levy a financial penalty for misconduct or maladministration, although they can replace any director, trustee, officer or employee. Excess remuneration (that is, an amount that is "excessive in relation to the property [of the charity]") for persons acting in the affairs of a charity is expressly listed as a form of misconduct or maladministration. (s. 18(3)) The Commissioners may, however, with the agreement of the Attorney-General, exercise that official's powers to take various legal proceedings involving charities, including enforcing trust obligations against defaulting trustees. (s. 32)

The English system focuses on the duties of trustees/directors and on protecting charitable assets. If problems develop, remediation is sought by improving a charity's internal governance. One illustration of this focus is the provision allowing the Commission to order a professional audit of a charity. The costs of the audit are to be borne by the directors/trustees. The funds of the charity are only to be used to cover the costs of the audit if the Commission considers it impractical to recover the expense from the directors/trustees individually. (s. 43(6))

<u>Arguments for and against imposing financial penalties on individuals</u>

Arguments against

- Making individuals liable to financial penalties may have an adverse impact on the recruitment of board members and employees. (However, an English observer says their country's emphasis on the responsibilities of a charity's board has not affected recruitment.)

- It is questionable whether trying to regulate directors' behaviour lies within federal jurisdiction. How is such a penalty necessary for the administration of the *Income Tax Act*? (The counter-argument would be that such a penalty would serve to protect tax-assisted funds.)

- Financial penalties against individuals are unnecessary because provisions already exist in the criminal law against fraud, theft, etc. You don't want to penalize individuals unless they deliberately set out to cheat a charity, and this is exactly what the criminal law requires. (The counter-argument is that criminal convictions are difficult, costly, and time-consuming to obtain because of the very high threshold of proof required. Administrative monetary penalties are more efficient.)

- Financial penalties for "excess benefits" raise the spectre of the regulatory authority substituting its own judgment on what is an appropriate salary for a decision taken by a charity's board. (However, provision can be made to target the penalty at clearly abusive situations, for example, by allowing for a "due diligence" defence.)

- Financial penalties on individuals are easily circumvented; a penalized individual would just get a "bonus" from the organization to compensate. (However, the legislation could forbid a charity to use its money in this way.)

- One theme in the chapter is to simplify the system as much as possible, so everyone knows what is required and the consequences of non-compliance. The *Internal Revenue Code* shows that financial penalties for something like an "excess benefit" requires complicated legislation, in order to satisfactorily define the contravention and precisely target its application.

Arguments for

- Penalizing directors may encourage them to take their responsibilities more seriously. For the few who are tempted to be wilfully negligent or complicit in the wrongdoing, it would serve as a deterrent.

- It is better to penalize directors, than the organization itself. If the organization is penalized, beneficiaries suffer, and money given by the public for charitable purposes is used to pay the penalty.

- Individuals are pursuable where an organization either can't pay because the individuals have drained the money out of it, or where it has no corporate existence. (However, in practice, it is not always clear who was in charge when the non-compliance occurred.)

- The money taken from the individuals by way of penalty can be re-applied to charitable purposes if the amount is returned to the original charity or another charity (depending on the degree of complicity/reckless disregard/etc. of the original charity).

Unresolved questions if Table recommends financial penalties on individuals

If there is to be a financial penalty on individuals:

- Which individuals should be penalized? Directors/trustees, officers, other employees, persons connected to the charity (for example, large donors).

- For what type(s) of non-compliance would a penalty be imposed? Excess benefit, others?

- At what rate should the penalty be set?

- How would "excess benefit" be defined? The preliminary definition suggested in December was:

    - A payment by the charity for goods, services rendered, or by way of remuneration, in excess of fair market value;
    - A sale by the charity (to someone other than a charitable beneficiary) at a price below fair market value;
    - A loan by the charity (to someone other than a charitable beneficiary) at a rate below fair market value.