# C. EXEMPTION OF CANADIAN CHARITIES UNDER THE UNITED STATES-CANADA INCOME TAX TREATY

**by**
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## 1. Introduction

Notice 99-47, 1999-36 I.R.B. 391 (Notice 99-47), provides guidance on the treatment of Canadian charities seeking exemption from federal income tax under the United States – Canada Income Tax Treaty (Treaty) and section 501(c)(3) of the Internal Revenue Code (Code). This article will review the provisions of the Treaty and Notice 99-47 governing the treatment of exempt organizations. This article will also provide general information and guidance on the treatment of Canadian charities seeking exempt status in the United States. Finally, this article will briefly discuss the oversight of Canadian charities by the Canada Customs and Revenue Agency, formerly Revenue Canada, and the types of data available from that agency.

## 2. Background

### A. General Rules Concerning Exemption of Foreign Charities

A foreign charity may qualify for recognition of exemption under IRC 501(c)(3) as formation outside the U.S. does not bar exemption under IRC 501(c)(3). See Rev. Rul. 66-177, 1966-1 C.B. 132. Like U.S. domestic charities seeking exemption under IRC 501(c)(3), a foreign charity must comply with all the requirements of IRC 501(c)(3) and the requirements of IRC 508, including the notification requirement of section 508(a).

A foreign charity may be a non-private foundation under IRC 509(a)(1), (2), or (3) or a private foundation. The same rules used to classify a domestic organization apply to a foreign charity. If a foreign private foundation receives 85 percent of its support (other than gross investment income) from sources outside the United States, the requirements of IRC 507 and IRC 508 and Subchapter A of Chapter 42 (the private foundation rules) are not applicable to that foreign private foundation. See IRC 4948(b) and Regs. 53.4948-1(b).

Contributions to a foreign charity exempt under IRC 501(c)(3) are not tax deductible under IRC 170(c). Specifically, IRC 170(c)(2)(A) provides that a contributor may take a charitable tax deduction on a donation under this code section provided that the exempt organization was created or organized in the United States or any possession of the United States. For a detailed discussion of foreign charities or foreign activities of domestic charities and the statutory structure concerning the aforementioned, please see 1992 CPE, Topic K, Foreign Activities of Domestic Charities and Foreign Charities, p. 220.

B. Exceptions to General Rules For Exemption of Foreign Charities When Tax Treaties are in Effect

The usual rules governing the recognition of exemption of foreign charities may not apply if an income tax treaty exists between the United States and another country. The United States has bilateral income tax treaties with many countries designed to help taxpayers avoid double taxation by the United States and the foreign country on the same income, to assist each country in administration of taxes, and to prevent tax evasion. An example of double taxation would be pension income received by a U.S. citizen residing in foreign country A, which may be subject to taxes imposed by both A and the United States, the former being the country of residency and the latter the country of citizenship. The United States may provide relief from such double taxation under a tax treaty by providing credits on taxes paid to A or *vice versa*.

Tax treaties usually deal with the tax treatment of income, estates, gifts and pensions, but some also contain provisions that govern the tax treatment of certain types of exempt organizations. An example of an income tax treaty containing such provisions is the United States – Canada Income Tax Treaty, a provision contained which specifically governs the treatment of Canadian charities seeking exemption from federal income tax and the deductibility of contributions made to Canadian charities. The Treaty also governs U.S. charities seeking tax exemption under Canadian laws, which is not the focus of this Article.

C. General Rules Concerning the Relationship Between Tax Treaties and Tax Code

A provision of a tax treaty is treated in the same way as with a provision of the Tax Code. See IRC 7852(d) and IRC 894(a). If there is a conflict between a treaty provision and the Code, the provision adopted later generally takes precedence over the other provision. See Reid v. Covert, 354 U.S. 1 (1956). Thus, if the U.S. has a tax treaty with a foreign country where a foreign charity is involved, the terms of the treaty in such a situation may govern the treatment of that foreign charity, not IRC 501(c)(3) and other applicable code sections. It is important that a determination be made whether the provisions in the treaty or the Code govern the treatment of that foreign charity. It also important to ascertain whether the Service provided guidance via notice, revenue procedure or revenue ruling on this particular treaty.

## 3. The United States – Canada Income Tax Treaty

This section of the article will describe some of the terms used in the Treaty, provide background information on the Treaty and describe the specific provision of the Treaty that deals with exempt organizations. It will also discuss Notice 99-47, which describes the procedures which Canadian charities must follow in order to be recognized as exempt from U.S. income tax by the Service.

### A. Descriptive Treaty Terminology

It is important to know certain terminology used in the Treaty to understand the overall treatment of Canadian (and U.S.) charities. These terms include the following:

- Contracting states – This term is used in the Treaty to describe the United States and Canada, the parties that entered into a "contract" (i.e., the Treaty);
- Protocols – On occasion a treaty is amended to reflect the need of the contracting states. An amendment to a treaty is known as a protocol;
- Competent Authority – the person designated by each respective country to handle communications and negotiations of treaty matters between the contracting states;
- Canada Customs and Revenue Authority – the organization so designated by Canada as the Competent Authority;
- Director, International, Large and Midsize Business Division, Internal Revenue Service – the office designated by the United States as the Competent Authority.

### B. Background

The current United States and Canada Income Tax Treaty was signed in 1980 and generally became effective on August 16, 1984, with the exchange of instruments of ratification between the two countries. As mentioned previously, the Treaty between the United States and Canada contains a provision that governs the treatment of U.S. or Canadian organizations seeking tax exemption in the other country. This provision is Article XXI of the Treaty.

Article XXI contains six paragraphs, dealing with the types of organizations that qualify for tax exemption; the types of income that qualify for tax exemption; the availability of deductions to U.S. donors of Canadian charities; and the availability of deductions to Canadian donors of U.S. charities.

The Treaty, however, does not specifically set out any procedures which a Canadian or U.S. organization may follow to obtain tax exemption in the other country. In the

United States, a Canadian organization would have to follow the procedures prescribed in Rev. Proc. 59-31, 1959-2 C.B. 949, which was promulgated under the revised U.S. – Canada Tax Convention of 1941 (Tax Convention). The Tax Convention was terminated with the ratification of the Treaty in 1984.

When the Treaty was signed, a letter or diplomatic note dated September 26, 1980 was exchanged between the representatives of the United States and Canada. It states that the Competent Authority of each contracting state will review the procedures and requirements for organizations of the other country to establish tax exemption under Article XXI of the Treaty. Once the Competent Authorities of both countries determine that the other country's procedures and requirements are comparable to their own, each Competent Authority will accept certification by the other that such an organization is an exempt organization under Article XXI. The purpose is to avoid filing of duplicate exemption applications and redundant reviews. For example, if a U.S. organization establishes tax exemption pursuant to U.S. procedures and requirements, Canada will accept such determination and recognize that organization as an exempt organization in Canada under the Treaty. The practical effect is that an organization will not have to qualify for tax exemption in both countries.

The Service announced in Notice 99-47 that the Competent Authorities of both countries reached an agreement to implement Article XXI as contemplated by the September 26, 1980 diplomatic note. Specifically, the provisions of Notice 99-47 govern the treatment of Canadian charities seeking exempt status in the United States. The Notice in effect supersedes the rules and procedures described in Rev. Proc. 59-31. (Notice 99-47 is reproduced in the appendix of this article).

C. Tax Exemption of Canadian Charities under Article XXI

Paragraph 1 of Article XXI provides for the exemption from tax organizations that are religious, scientific, literary, educational, or charitable. Note that amateur athletic organizations and testing for public safety organizations, which are described in IRC 501(c)(3), are not listed among the types of organizations eligible for exemption under the Treaty.

The income of these organizations is exempt from tax of a contracting state to the extent that it is exempt from taxation in the other contracting state where it is a resident. For example, if a charity is a religious, scientific, literary, educational or charitable organization within the meaning of Article XXI, and resides in Canada, the U.S. source income it receives is exempt from U.S. income tax to the extent that the charity is exempt from Canadian income tax. This rule is the same for recognized United States charities regarding exemption from Canadian income tax.

Another type of organization exempt under the Treaty is a fund, company or organization that is operated exclusively to administer or provide pensions, retirement or employee benefits. See Article XXI, paragraph 2. These organizations are exempt from income and withholding taxes.

D. Canadian Private Foundations

Under the Treaty, there is a special provision concerning a Canadian charity that is a private foundation. If the Canadian private foundation receives "substantially all" (85 percent or more) of its financial support from persons who are non-U.S. citizens or residents, it is exempt from excise taxes imposed on private foundations by the United States. See Article XXI, paragraph 4. This excise tax exemption also includes taxes imposed by section 4948(a). See Reg. 53.4948-1(a)(3). (This exemption from taxes imposed by section 4948(a) was also described in Rev. Rul. 74-183, 1974-1 C.B. 328, which was promulgated pursuant to the Tax Convention. Rev. Rul. 74-183 in effect became obsolete with the termination of the Tax Convention.)

E. Unrelated Business Income

An exempt organization's income from an unrelated trade or business is not exempt from taxation under the Treaty. Income derived from a related person that is not an exempt organization is also not exempt from taxation. An example is an exempt organization that owns a subsidiary that carries on a business: income derived therefrom would not be exempt from taxation under the Treaty. See Article XXI, paragraph 3.

4. Notice 99-47: Qualifications for Automatic Recognition Exemption of Canadian Charities

As described in the Notice, the Service will automatically recognize a Canadian charity as exempt from U.S. income tax if the following requirements are satisfied:

- the organization is organized under the laws of Canada;
- the organization is a religious, scientific, literary, educational or charitable organization;
- the organization has been recognized by Canada as a registered Canadian charity.

Similarly, Canada will automatically recognize the tax-exempt status of a U.S. charity if:

- the organization is organized under laws of the United States;

- the organization is a religious, scientific, literary, educational or charitable organization;
- the organization has been recognized by the Service as exempt under IRC 501(c)(3).

Once a Canadian registered charity is recognized as exempt, the recognition of exemption remains in effect until Canada withdraws its registration or the Service determines that that Canadian registered charity fails to satisfy the requirements for exempt status under IRC 501(c)(3) and the rules and regulations thereunder.

A. Private Foundation Classification and Canadian Registered Charities

Because Canada's and the United States' provisions for "private foundations" are not comparable, Notice 99-47 provides that a Canadian registered charity presumed to be a private foundation under IRC 509(a). The deduction limitation of 30 percent (rather than the 50 percent for public charities) under IRC 170(b) will apply to U.S. donors on their Canadian source income. To rebut this presumption, the Canadian Charity may submit to the Service the proper financial information needed to determine the appropriate foundation classification.

B. Publication 78, Cumulative List of Organizations

A major benefit for submitting the financial information for foundation classification purposes is that a Canadian registered charity will be listed in Publication 78, Cumulative List of Organizations, even if the charity is determined to be a private foundation.

As a practical matter, many U.S. donors would be reluctant to contribute to Canadian registered charities without assurance from the Service that contributions are charitable contributions for U.S. income tax purposes. The limited deductibility, generally to the extent of the donor's Canadian source income, is discussed below. The Notice specifically requires that a donor claiming a charitable contribution made to a Canadian charity be required to show that the organization is in fact a Canadian registered charity. Hence, another benefit for submitting the financial information (and be listed in Publication 78) is the assurance to the donors that their contributions are charitable contributions under IRC 170.

C. Effect on IRC 508 Notification Requirement

IRC 508(a) and the regulations thereunder provide that the Service will not recognize an organization as exempt under IRC 501(c)(3) if the organization does not give notice with the Service. Given the fact that Notice 99-47 provides for the automatic recognition of exemption, made pursuant to the Treaty and enacted after the passage of IRC 508, the Treaty overrules the notice requirement of IRC 508. Thus, IRC 508 does not apply.

D. Filing and Disclosure Requirements Applicable to Canadian Registered Charities

All exempt organizations and private foundations, with some exceptions, must file annual information returns that include Form 990, Return of Organizations Exempt From Income Tax or Form 990-PF, Return of Private Foundation. See IRC 6033(a). Although Canadian registered charities need not file Forms 1023 with the Service to be recognized as exempt from U.S. income tax, they are not exempt under the Treaty or Notice from filing annual information returns. Rather, exceptions to the filing requirement are described by IRC 6033(a) and the regulations thereunder.

Under Rev. Proc. 94-17, 1994-1 C.B. 579, a Canadian registered charity (other than a private foundation), similar to the relief offered any foreign organization (other than a private foundation), is relieved from filing the Form 990 for any year in which it has gross receipts of $25,000 or less from United States source income and has no significant activity in the United States.

Canadian registered charities must also make available their annual information returns for public inspection as prescribed under IRC 6104. Neither the Treaty nor Notice exempt Canadian registered charities from this disclosure requirement (since a Canadian registered charity does not file a Form 1023 for U.S. exemption purposes, there is no public inspection of said form). For detailed discussions of filing requirements of exempt organizations, please see 1997 CPE, Topic B, Publicity and Disclosure of Form 990, and 2000 CPE, Topic O, Update: The Final Regulations on the Disclosure Requirements for Annual Information Returns and Applications for Exemptions.

E. Additional Disclosure Requirement - IRC 6114

Specifically, IRC 6114 provides that if a taxpayer takes advantage of the benefits provided under a treaty and such treaty overrules or modifies a provision of the Code, that taxpayer must disclose such position to the Service.

As discussed above, a Canadian registered charity is automatically recognized by the Service to be exempt without filing a Form 1023 exemption application. Nevertheless, a Canadian registered charity must disclose to the Service that it is exempt from U.S. income tax. Disclosure is done by filing Form 8833 along with the information return required under IRC 6033. If a Canadian registered charity is exempt from filing an information return under IRC 6033, it needs only to file Form 8833.

This notice requirement is also applicable to individual U.S. contributors of Canadian registered charities seeking to claim charitable deductions. See Notice 99-47.

5. Limited Deductibility of Contributions Under the Treaty and Notice

Contributions made by a U.S. citizen or resident to a Canadian registered charity are treated as charitable contributions for purposes of IRC 170(c). See Article XXI, paragraph 5 and Notice 99-47. However, the charitable tax deduction is subject to two restrictions. First, a U.S. donor may use the deduction only against its *Canadian source income*. Second, the deduction is subject to the percentage limitations described in IRC 170(b). The percentage limitations permit a U.S. donor that made charitable contributions to a Canadian registered charity classified as a private foundation to deduct up to 30 percent of the donor's income derived from Canada. Any excess may be carried over and deducted in subsequent taxable years. This percentage amount is raised to 50 percent if the Canadian registered charity is classified as a non-private foundation under IRC 509(a)(1) or IRC 509(a)(2). (The percentage limitation does not apply where the Canadian registered charity is a Canadian college or university at which the donor, or a member of the donor's family, is or was enrolled (see Article XXI, paragraph 5)).

This deduction rule mirrors the rule that governs contributions made by a Canadian citizen or resident to a U.S. charity. See paragraph 6, Article XXI. Also, a U.S. donor may have to file the Form 8033 along with his or her income tax return if that person claims a charitable contribution deduction. See Notice 99-47.

## 6. Charities Regulations in Canada

The income of charities residing or carrying on business in Canada is exempt from Canadian tax under section 149 of the Income Tax Act (ITA). Under the ITA there are two types of charities. These are charitable organizations and charitable foundations.

A charitable organization is one in which all of the resources are devoted to charitable activities carried on by the organization itself, though it may also fund other registered charities and carry on a related business.

A charitable foundation is organized and operated exclusively for charitable purposes, and are either public or private. Canadian provisions, however, are not similar to the IRC definition of private foundation. A public foundation generally funds other registered charities and may carry on a related business. A private foundation is defined as a charitable organization that is not a public foundation. Accordingly, a private foundation is one in which either (a) more than 50 percent of the directors, trustees, officers, or similar officials do not deal with each other at arm's length; or (b) more than 50 percent of the capital contributed to the foundation has been contributed by one person or member of a group that does not deal with the foundation at arm's length.

In addition to the general rules described above, there are also stricter income tax rules placed on foundations (and private foundations in particular) dealing with disbursement quotas, transfers of property tax, gifts of non-qualifying property, and the registration revocation tax.

Tax relief is available under the ITA for donations to charities, which include: registered charities; registered Canadian amateur athletic associations; housing corporations resident in Canada and exempt from tax under the ITA; Canadian municipalities; the United Nations or an agency thereof; universities outside Canada the student bodies of which ordinarily include students from Canada; charitable organizations outside Canada to which Her Majesty in Right of Canada has made a gift during an individual's taxation year or the 12 months immediately preceding the taxation year, or Her Majesty in Right of Canada or a province. Excess credits for charitable contributions may be carried over for 5 years under the ITA.

The Canada Customs and Revenue Agency (CCRA), formerly, Revenue Canada, is the Canadian government agency responsible for promoting and enforcing compliance with Canada's tax, trade, and border legislation and regulations. The Charities Division of the CCRA reviews applications from organizations or groups that want to register as a

charity, gives technical advice on operating a charity, and handles audit and compliance activities.

It is responsible for the development and publication of forms, interpretation bulletins, information circulars, brochures and guides, newsletters and draft publications related to charities in order to educate the public regarding their rights and obligations. It also maintains a list of registered Canadian charities, which can be searched online, calling the Charities Division toll-free with bilingual service at 1-800-267-2384 (English) or 1-888-892-5667 (bilingual), or writing to the Charities Division; Canada Customs and Revenue Agency; Ottawa, ON K1A 0L5.

Similar to Notice 99-47 published by the IRS, CCRA has also included guidance on the implementation of Article XXI of the Canada-U.S. income tax treaty, through publication of an information circular, interpretation bulletin, and a registered charities newsletter. For further information concerning tax information provided by CCRA, see its websites: www.ccra-adrc.ca./menu-e.html or www.ccra-adrc.gc.ca/tax/charities/menu-e.html.

## 7. Conclusion

The purpose of Notice 99-47 is to facilitate the exemption application process of charities in one country that is seeking exemption in the other country. It is designed to remove unnecessary duplication of exemption procedures while ensuring that exempt organizations residing in the other country are in compliance with all the rules and regulations therein. The Service is revising the IRM to reflect the changes made by Notice 99-47.

**APPENDIX**

## Notice 99-47

Guidance Relating to Article XXI of the United States-Canada Income Tax Convention

1999-36 I.R.B. 344; Notice 99-47

September 7, 1999

PURPOSE

This notice provides guidance concerning a competent authority agreement between the United States and Canada that implements Article XXI (Exempt Organizations) of the United States-Canada Income Tax Convention (Treaty).

BACKGROUND

Article XXI of the Treaty generally provides for deduction of cross-border charitable contributions, and reciprocal recognition of exemption for religious, scientific, literary, educational, or charitable organizations. Diplomatic notes that accompany the Treaty provide that the competent authorities of each of the Contracting States shall review the procedures and requirements for an organization of the other Contracting State to establish its status as a religious, scientific, literary, educational, or charitable organization entitled to exemption under paragraph 1 of Article XXI, or as an eligible recipient of the charitable contributions referred to in paragraphs 5 and 6 of Article XXI, with a view to avoiding duplicate application by such organizations to the administering agencies of both Contracting States. The diplomatic notes also provide that if a Contracting State determines that the other Contracting State maintains procedures to determine such status and rules for qualification that are compatible with such procedures and rules of the first-mentioned Contracting State, it is contemplated that such first-mentioned Contracting State shall accept the certification of the other administering agency of the other Contracting State as to such status for the purpose of making the necessary determinations under paragraphs 1, 5 and 6 of Article XXI.

SCOPE OF TREATY RELIEF

The U.S. and Canadian Competent Authorities, pursuant to Article XXVI (Mutual Agreement Procedure) of the Treaty, have entered into a mutual agreement that implements Article XXI as contemplated by the diplomatic notes. Under the terms of the agreement, recognized religious, scientific, literary, educational, or charitable organizations that are organized under the laws of either the U.S. or Canada will automatically receive recognition of exemption without application in the other country.

U.S. organizations must be recognized as exempt under section 501(c)(3) of the Code in order to qualify for this treatment. Similarly, Revenue Canada must recognize Canadian organizations as Canadian registered charities.

Moreover, recognized charitable organizations resident in one country will be eligible to receive deductible charitable contributions from residents of the other country. However, in the case of a contribution (or contributions) by a resident or citizen of the United States (other than a contribution to a college or university at which the citizen or resident or a member of his family is or was enrolled), U.S. law requires that the amount of deductions in the aggregate for a taxable year may not exceed a certain percentage of the donor's Canadian source income. Any excess contribution that is not deductible as a result of this limitation may be carried over and deducted in subsequent taxable years, subject to the same limitations.

Furthermore, the U.S. will presume, in the absence of receiving certain financial information, that all Canadian registered charities are private foundations. Accordingly, if a Canadian registered charity does not provide the U.S. with the financial information needed to determine its foundation classification, the organization will be presumed to be a private foundation under U.S. law, the donor's deductible contributions will be limited to 30 percent of the donor's Canadian source income, and the organization will not have the benefit of being listed in Publication 78, Cumulative List of Organizations. Moreover, although the Canadian registered charity will not be required to apply for exemption, a donor claiming a charitable contribution deduction will be required to show that the organization is a Canadian registered charity.

Alternatively, if a Canadian registered charity provides the U.S. with the information needed to determine its foundation classification, aside from automatic recognition of exemption, the organization will be listed in Publication 78, as a foreign organization, and will be eligible to receive contributions deductible up to 50 percent of the donor's Canadian source income, assuming it is determined not to be a private foundation. If the Canadian registered charity submits information that establishes that it is a private foundation, it will nevertheless be listed in Publication 78, but deductible contributions will be limited to 30 percent of the donor's Canadian source income.

Under the agreement, recognition of exemption by the U.S. of a Canadian registered charity will remain in effect until the U.S. determines that the organization fails to satisfy the requirements for exempt status under U.S. law. Further, Canadian organizations will be required to file the applicable Form 990, Return of Organizations Exempt From Income Tax, or Form 990-PF, Return of Private Foundation, unless they receive less than $ 25,000 of U.S. source income.

## DISCLOSURE REQUIREMENT

Section 6114(a) of the Code requires that taxpayers taking the position that a U.S. treaty overrules a general U.S. tax principle or law must disclose such position on a return of tax or, if no return of tax is required to be filed, as the Internal Revenue Service may prescribe. Accordingly, taxpayers claiming exemption or charitable contribution deductions pursuant to this agreement must disclose this position on their income tax return for the year in which the charitable contribution deduction or claim for exemption is made. Taxpayers may use Form 8833 for this purpose, or they may attach to their return a separate statement indicating that they are claiming exemption or a charitable contribution deduction pursuant to Article XXI of the Treaty. Taxpayers may make reference to this Notice 99-47 in their disclosure statement.

## DRAFTING INFORMATION

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