Intersections and Innovations

Change for Canada's Voluntary and Nonprofit Sector

The Muttart Foundation

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The Muttart Foundation

Acknowledgements

For far too long, Canada has lacked a comprehensive resource examining Canada's charitable sector. That has now ended.

The Muttart Foundation has spent many years focusing on building the capacity of charities in this country. The publication of this collection is another contribution to that effort. By understanding more about itself, the sector can continue to develop and find new ways to serve Canadians and those in need outside our nation.

The authors of these essays bring different perspectives on the role and inner workings of Canada's charities. Collectively, they bring an unprecedented insight into the work of organizations whose diversity is exceeded only by their desire to serve.

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The work of all of these individuals has come together in this resource which we dedicate to all of those in, or interested in, Canada's charitable sector.

Malcolm Burrows, President

Bob Wyatt, Executive Director

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Part II Navigating a Changing Environment

Governance and the Regulatory Environment

The Funding Environment

The People Environment: Leaders, Employees, and Volunteers

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Governance and the Regulatory Environment

Chapter 6

Regulating Business Activity

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Charities and nonprofit organizations (NPOs) have come under increasing pressure to consider innovative ideas to generate revenue, employing novel methods and structures to achieve their goals. Although government funding of charities and NPOs has increased during the COVID-19 pandemic, there will likely be a downturn in revenues for those that rely on public donations and fundraising. As a result, these organizations will be further pressed to consider alternative revenue sources. This leads to a question: under Canadian law, are charities and NPOs permitted to operate a business?

The answer first requires consideration of what is a business? When does revenue generation become a business? The relevance of these questions has significant implications for both Canadian registered charities and other NPOs. Under the current system, Canadian charities have significant flexibility to generate revenue, provided the activity can be related to the purpose of the organization. NPOs have a more difficult time with revenue-generating operations because they cannot have a profit purpose.

Sector advocates have called for reforms in this area of the law to give both registered charities and NPOs greater flexibility to engage in business activities (Special Senate Committee on the Charitable Sector, 2019). Many in the sector have pushed for the adoption of the “destination of funds” test[1] that has been accepted in other Commonwealth jurisdictions. Adoption of this test would allow charities and NPOs to operate business activities to raise funds, so long as the funds are put toward a charitable or nonprofit purpose.

The regulations that are critical to this issue for either an NPO[2] or a registered charity are in the Income Tax Act (1985) (ITA), but different rules apply to each category of entity.

Discussion of charity and business in tandem raises the notion of "social enterprise." The term has been used to describe myriad structures combining social goals and commercial activities, and many describe the revenue-generating activity of registered charities and NPOs as social enterprises – and that they may be. For our purposes, the reference to these activities as social enterprises is irrelevant. The focus in this discussion is how and when these organizations can pursue revenue generation, and how the regulatory environment might evolve to enable them to take advantage of the opportunities to further support their mission.

This chapter focuses on the regulation of business activity by a registered charity and certain NPOs. It will examine the rules in the ITA, case law, and the Canada Revenue Agency (CRA) policies, guidance, and technical interpretations that govern the business activities of a charity or an NPO. It then describes structures used to comply with the rules. It concludes with a policy discussion that includes a review of approaches in other jurisdictions and suggests possible reforms to Canada's regulation of revenue generation in the voluntary sector.

Legislative Framework

Types of Corporate Structures

A starting point to our discussion is to appreciate that organizations can be legally incorporated in several different ways in Canada, with differing implications for how profits from business activities are treated.

Non-Share Capital Corporations

Non-share capital corporations may be established under the Canada Not-for-Profit Corporations Act (2009) or analogous provincial legislation (Companies Act, n.d.; Companies Act, 1973; Companies Act, 1988; Corporations Act, 1990; Corporations Act, 1990; Societies Act, 1988; Societies Act, 1989; Societies Act, 2000; Societies Act, 2002; Societies Act, 2015; Corporations Act, n.d.; Non-Profit Corporations Act, 1995). Such entities generally set out the purpose for which they exist in their corporate documents. The members of a non-share capital corporation are essentially the equivalent of shareholders of a business corporation and have ultimate control of the corporation through their power to elect and remove directors and approve fundamental corporate decisions. A key requirement of a non-share capital corporation is that the income is not distributed to the members. Unlike for-profits, non-share capital corporations do not earn revenue to benefit their owners. Rather, the surpluses earned are applied to further the identified purpose of the organization. Charitable organizations and NPOs are typically incorporated as non-share capital corporations.[3]

For-Profit Corporations

For-profit corporations are incorporated under the Canada Business Corporations Act (1985) or analogous provincial legislation. The central goal of a business corporation is to maximize profits for its shareholders. The shareholders are entitled to an interest in the underlying assets of the entity. This makes it quite distinct from the non-share capital corporations used by the voluntary sector. Any social or environmental objectives the business may have will generally come second to financial return for its owners. Unlike non-share capital corporations, for-profits are not limited in their purposes, and they can raise capital through the issuance of shares and debt instruments.

Hybrid Corporations

Hybrid corporations are relatively new. A hybrid corporation is typically a for-profit share capital corporation that commits to operating its for-profit business in a socially responsible and sustainable manner. Hybrid corporations generally earn a profit for their investors while achieving a social benefit, although they may restrict shareholder returns to make funds available for the social goals of the corporation. These hybrids are often offered up as a vehicle through which charities and NPOs could generate revenue without tainting their tax-exempt status. Hybrid entities have gained popularity in several countries, notably the United Kingdom and the United States. More recently, British Columbia (Business Corporations Act, 2002) and Nova Scotia (Community Interest Companies Act, 2012) each established a legislated form of hybrid corporation.

British Columbia's Business Corporations Act (2002) introduced the "community contribution company" (C3) in 2013. C3s are share capital corporations with a "community purpose" that can include health, social, environmental, cultural, or educational objectives or focus on providing other services to society at large (Business Corporations Act, 2002). The legislation provides for a 40% cap on shareholder dividends and requires that 60% of the C3's assets flow to one or more qualified entities on dissolution.[4] In 2016, Nova Scotia introduced the "community interest corporation" (CIC) under the Community Interest Companies Act (2012). Similar to C3s, CICs are share capital corporations with a community purpose. However, upon dissolution, all of a CIC's assets must be distributed to a narrower group of one or more qualified entities.[5]

What Do the Canadian Rules Say about Business Activities?

Charities and NPOs, while both established for purposes other than profit, are distinct entities subject to different laws and regulations, and different rules apply when asking how each organization can engage in business activities.

Registered Charities

There is no definition of a charity in the ITA. Under the ITA (s. 248(l)), a registered charity is defined as an entity that is resident in Canada, was created or established in Canada, and has applied and been registered by the Minister of National Revenue as a charitable organization or as a public or private foundation. Charitable organizations typically engage in their own charitable activities, whereas charitable foundations generate revenue to gift to other charities.

A charitable foundation is categorized as a public foundation if more than 50% of the foundation's directors, trustees, officers, or like officials deal at arm's length with each other (ITA, s. 149.1(1)). A public foundation cannot be controlled directly or indirectly by a person or group of people who do not deal with each other at arm's length and who have contributed more than 50% of the capital of the public foundation (ITA, s. 149.1(1)). A foundation that does not meet the requirements of a public foundation is designated as a private foundation (ITA, s. 149.1(1)).

All charities must be established for exclusively charitable purposes (ITA, s. 149.1(1)). A charity's object(s), as set out in its constating (incorporation) documents must further one or more recognized charitable purposes, including 1) relief of poverty, 2) advancement of education, 3) advancement of religion, and 4) public benefit determined by the courts (*Guaranty Trust Co. of Canada v Minister of National Revenue*, 1967; *Pemsel*, 1891). Further, a charity's purposes and activities must provide a benefit to the public or a significant section of the public (*McGovern v Attorney General*, 1982). Although a charity must provide a public benefit, it cannot confer a benefit to any one individual in particular (ITA, s. 149.1(1)). In other words, subject to limited exceptions, a charity cannot confer a private benefit on a third party that is not a beneficiary of the charity's purposes (Canada Revenue Agency, 2006, s. 3.2.4).[6] Further, a charitable organization's expenditures, assets, and resources must be directed only to activities that advance its charitable purposes (*Alliance for Life v Minister of National Revenue*, 1999).

Charitable organizations and charitable foundations must both meet annual spending requirements, meaning that they must spend a minimum amount each year on their charitable activities or gifts to qualified donees, such as other registered charities (ITA, s. 149.1(2)(b); s. 149.1(3)(b); s. 149.1(4)(b)).

Charities and business activities

Although charities have engaged in revenue-generating activities for years, they have done so under a complex array of rules and restrictions. Their revenue-generating activities are varied, ranging from operating gift shops, restaurants, and cafés to the licensing or sale of marketable software and agricultural products.

While charities may engage in business, how they do so is quite distinct from for-profit businesses. Charities do not answer to shareholders, nor do they gauge their success on profitability. Instead, they are held to account by their members and regulators. Their success is marked not by profit margins but by measures such as fundraising efficiency and dollars spent on programs. The one similarity between charities and for-profit businesses is that to be successful, they both must be able to raise capital to fund their ongoing operations and pursue their ultimate purposes.

Generally, all of a charity's resources must be devoted to furthering its charitable purposes. Resources used for other purposes, such as a business, are subject to strict regulation. The ITA explicitly permits charitable organizations and public foundations to carry on "related businesses" (s. 149.1(6)(a); s. 149.1(3)(a)). Charities designated as private foundations cannot carry on any business, related to the charitable purpose or not (ITA, s. 149.1(4)(a)).

"Related business" lacks a precise definition in the ITA, which has led to much confusion in this area of the law. Pursuant to the ITA, a related business includes a business that is unrelated to the purposes of the charity if substantially all persons employed by the charity in the carrying on of that business are not remunerated for that employment (s. 149.1(1)). The framing of the related business definition in this inclusive way leaves the issue of "what else" is permitted open to interpretation.

Two Canadian cases that have attempted to define "related business" differ in their interpretation, making this area of the law all the more puzzling. In *Alberta Institute on Mental Retardation v The Queen* (1987), the court held that the sale of donated household items to a retailer was closely associated with the objects of the organization because the profits of the activity were given to charitable organizations (as set out in the organization's objects) (para. 8). The court explained that even if the collection and sale of used goods constituted a business, it was a "related business," likening it to the operation of a cafeteria in an art gallery (para. 17). Under this "destination of funds" approach, a charity's business is permissible if its profits are furthering the organization's purposes. This was a welcome approach.

The Federal Court of Appeal in *Earth Fund v Minister of National Revenue* (2002), unfortunately, rejected the approach taken by the court in *Alberta Institute* (1987). The court did not accept that *Alberta Institute* was "authority for the proposition that any business is a 'related business' of a charitable foundation if all of the profits of the business are dedicated to the foundation's charitable objects" (*Earth Fund v Minister of National Revenue*, 2002, para. 30). To the charitable sector's dismay, the court specifically rejected the destination-of-funds test, failed to clearly define "related business," and did not provide a definitive test to determine when a business is in fact "related." The net result is that after *Earth Fund*, embarking on revenue-generating activities in such an uncertain environment became unattractive.

In response to the uncertainty in the case law, CRA published its Policy Statement CPS-019 (2003) summarizing its position on the business activities of charities. While CRA statements, rulings, and technical interpretations are not legally binding (*Owen Holdings Ltd. v The Queen*, 1997), they reveal, to some extent, how CRA administers the rules in the ITA and makes decisions regarding the operations of charities. Unfortunately, CRA commentary also often receives deference from the courts (*BBM Canada v Minister of National Revenue*, 2008, para. 46). CPS-019 sets out a two-step approach to determine if an activity is an acceptable related business: 1) determine if the activity constitutes a business, and 2) if it is a business, determine if it is a related business or an unrelated business. With respect to the first step, CRA considers several factors when determining whether a particular activity is a business activity: 1) a profit purpose, 2) potential to show a profit, 3) a history of profits, and 4) whether the people selected to carry out the activity were chosen because of their commercial expertise (Canada Revenue Agency, 2003; *Stewart v Canada*, 2002). According to the policy (para. 6), not all revenue-generating activities operated with an intention to profit are business activities. One example of an acceptable activity with a profit motive is a fundraiser. CRA (para. 12) explains that fundraisers are not caught by the related business provisions because fundraisers are not continuous operations that amount to "carrying on" a business. CRA (2012, para. 54) will examine the frequency of the fundraising activity: the more regular the activity, the more likely it is to be categorized as a business.

CPS-019 also confirms that fees are permissible for certain charitable programs. CRA (2003, para. 7) identifies three indicators that a charitable program involving a fee is not a business: 1) the fee structure is designed to cover the costs of the program rather than to generate a profit, 2) the program does not offer services comparable to those otherwise available in the marketplace, and 3) fees are set according to a charitable objective as opposed to a market objective.

Finally, CPS-019 states that soliciting donations, probably the most common charitable activity, does not constitute a business activity. This is the case for both cash gifts and gifts-in-kind.[7] CRA would likely not deem the resale of donated items to be a business. CRA notes that by selling donated items, a charity does not assume the costs or risk associated with buying goods for resale (para. 5). CRA (para. 5) will also consider whether the donated good is processed before resale, explaining that while selling donated goods may be fundraising, cutting and re-manufacturing donated clothing and then selling it constitutes a business.

The statements made by CRA about these examples of revenue-generating activities illustrate that the related business regime, although intended to be a concession to registered charities, is fraught with inconsistency. To suggest that fundraising isn't an ongoing activity for most charities is likely not supported by the evidence. A destination-of-funds test would avoid this concern.

CRA also suggests that the fact that for-profit entities may offer similar programs or services should be considered. If the tax policy position behind the tax exemption is accepted as the creation of surplus to support the charitable purpose, rather than to create wealth, this factor should not be relevant. CRA's statement that a similar provision of services moves something from charitable to business is not correct in law – if the revenue-generating activity is part of the delivery of charitable programming, it should be acceptable.

Ultimately, classification of an activity as a business is a question of fact. If the conclusion can be reached that the revenue generated is from charitable programs, the analysis ends. If the conclusion is that the charity is running a business, the analysis does not stop there. Operating a business activity will not make a charity noncompliant. The determination of whether a charity's business activity is offside the ITA requires the further consideration of whether that activity is a related or unrelated business. Again, this determination is made on a case-by-case basis.

Generally, for a business activity to be considered related, it must bear some relationship to the accomplishment of the charity's charitable purposes (Canada Revenue Agency, 1998). CRA (2003, para. 18) classifies related businesses into two types: 1) businesses run substantially by volunteers, and 2) businesses linked to a charity's purpose and subordinate to that purpose. The definition of "related business" in paragraph 149.1(1) of the ITA expressly provides for the first category. If an activity is run substantially by volunteers – that is, 90% of people running the activity, including direct employees and sub-contractors, are volunteers – it constitutes a permitted related business (Canada Revenue Agency, 2003, para. 18). If a business activity is not run substantially by volunteers, the definition in the ITA is silent and, as indicated, the case law has been unhelpful. CPS-019 reflects CRA's administrative policy on when a business is related. It states that the activity will be a related business if it is *both* linked and subordinate to the organization's charitable purposes. CRA (2003, paras. 20–30) states that a business is *linked* to a charity's purpose(s) if it falls into one of four categories: 1) a usual and necessary concomitant of charitable programs, 2) an offshoot of a charitable program, 3) makes use of excess capacity, or 4) involves the sale of items that promote the charity or its objects. Art gallery gift shops and hospital cafeterias are common examples of businesses linked to a charity's purpose(s).

CRA (2003, paras. 31–43) states that the activity is a *subordinate* where: 1) relative to the charity's operations as a whole, the business activity receives a minor portion of the charity's attention and resources, 2) the business is integrated into the charity's operations, rather than acting as a self-contained unit, 3) the organization's charitable goals continue to dominate its decision-making, and 4) the organization continues to operate for an exclusively charitable purpose by, among other things, permitting no element of private benefit to enter into its operation.

Consider the example of a charity with the purpose to protect the environment by conserving the habitats of Canada's endangered species. To raise funds, the charity decides to operate exotic animal shows. The exotic animal shows will be made available for children's birthday parties and other celebrations. The shows will be run by paid staff and will receive a minor portion of the charity's attention and resources. This business activity is likely to be subordinate but not linked to the charity's purposes. Therefore, CRA would likely deem it to be an unrelated business, not allowed.

The related business rules were introduced as a concession to registered charities in Canada in response to common law that suggests a charity can never have business activity. These rules were introduced at a time when the need for revenue generation was not as acute. Noncompliance with the rules comes with harsh consequences. CRA may revoke a charity's registration if it determines that the charity carries on an unrelated business (ITA, s. 149.1(2)(a); s. 149.1(3)(a)). It also has the ability to issue financial penalties (ITA, s. 188.1). If an organization describes an unrelated business in its application for charitable registration, the application will be denied (Canada Revenue Agency, 2003, para. 45), and it must eliminate or restructure the activity before reapplying for charitable registration.

Nonprofit Organizations

NPOs are organizations that are not registered charities but which otherwise qualify for tax exemption by meeting certain requirements under the ITA. There are many unique categories of tax-exempt organization contained in s. 149(1) of the ITA, some of which might be considered generally to fall into the bucket of NPO. For the purposes of this chapter, we are focused on the largest nongovernment category of NPOs – the organizations that claim tax-exempt status under paragraph 149(1)(I) of the ITA. Such NPOs are not required to apply for a tax-exempt status in order to qualify as an NPO. The types of organizations that claim this exemption range from "mutual benefit" NPOs to "public benefit" NPOs. In other words, professional associations or marketing groups may rely on the same provision for the exemption from tax as do community soccer leagues and youth organizations. They annually assert their entitlement to the tax exemption when filing a corporate tax return.

To claim this exemption, an organization must meet the following requirements (Canada Revenue Agency, 2001, para. 1; ITA, s. 149 (1)(l)):

a. it is not a charity;
b. it is organized exclusively for social welfare, civic improvement, pleasure, recreation, or any other purpose except profit;
c. it is in fact operated exclusively for the same purpose for which it was organized or for any other purposes mentioned in (b); and
d. its income is not available for the personal benefit of a member (subject to certain exceptions).

With respect to the first requirement, an NPO cannot have a purpose or purposes recognized as charitable under the four heads of charity. Instead, it must be organized and operated exclusively for social welfare, civic improvement, pleasure, or recreation or for any other purpose except profit. "Social welfare" involves providing assistance to disadvantaged groups (Canada Revenue Agency, 2001, para. 5). "Civic improvement" includes enhancement of value or quality of community or civic life (Canada Revenue Agency, 2001, para. 5). "Pleasure or recreation" means providing a state of gratification or a means of refreshment or diversion (Canada Revenue

Agency, 2001, para. 5). In other words, hobbies or pastimes. "Any other purpose except profit" is a catchall phrase for organizations organized and operated for other than commercial reasons (Canada Revenue Agency, 2001, para. 5). The requirement that an NPO cannot operate for a profit purpose has led to much debate. CRA has recently opted to rely on that phrase in a strict manner.

The final requirement that "no part of the income is payable to or otherwise available for the personal benefit of the member" is a critical element of the definition that speaks to the objective behind the revenue generation or "profit."

Nonprofit Organizations and Business Activities

A separate set of rules and possible consequences apply to NPOs engaged in business activities than to registered charities. Many smaller and community-based organizations in the voluntary sector are not registered charities. The requirement for exclusively nonprofit purposes with limited exemptions leads to a more restrictive revenue-generating environment for such organizations than for registered charities.

As noted, to qualify as a tax-exempt NPO under paragraph 149(1)(l), an organization must be organized and operated exclusively for social welfare, civic improvement, pleasure, recreation, or any other purpose except profit. The interpretation of "any other purpose except profit" is the area of greatest concern. The difficult question is what factual evidence is looked to when determining whether an organization has a "profit" purpose. If the analysis was primarily based on the issue of making income available for the personal benefit of members or the creation of wealth for those who control the organization, an NPO could securely establish this when it qualifies for the tax exemption. Unfortunately, CRA administers the provision much more restrictively, embarking on an analysis of the operation of the NPO and considering whether boards or management are operating with the *intent* to make a surplus or profit. The error in this is arguably that the governing body of any NPO could be challenged for not meeting their fiduciary duties if they operate in a deficit position. This conflict has made it very difficult for NPOs to obtain advice on the issue of qualification for tax-exempt status.

NPOs must be careful to ensure that profits from one activity are not used to cover expenses of another activity, as this will indicate a profit purpose (Canada Revenue Agency, 2011). The court in *BBM Canada v Minister of National Revenue* (2008) described this as a "threshold test": an entity cannot qualify for the tax exemption if it is unable to accomplish the objectives for which it was established unless it realizes profits with which to do that (para. 45). Otherwise, the jurisprudence has not developed a set of factors or criteria that enable a clear determination of whether an NPO has a profit purpose (*Canadian Bar Insurance Association v The Queen*, 1999; *Gull Bay Development Corporation v The Queen*, 1984). Again, given the lack of adequate case law, CRA has developed several policies that take a narrow approach to the issue. In determining whether an NPO is operating for a profit purpose, CRA will consider:

a. whether the organization budgets for a surplus of revenue over expenses; and
b. whether the organization has accumulated funds that exceed its needs in carrying out its nonprofit purposes (Canada Revenue Agency, 2001, paras. 8–9; 2002).[8]

CRA (2001) will question the nature of the surplus funds, including 1) how and why the surplus was accumulated, 2) the length of time over which the surplus has been accumulated, and 3) whether the organization is taking reasonable business steps to reduce the surpluses; for example, by adjusting the costing of its products or services.

CRA will question activities that have a commercial character, suggesting that they are in furtherance of a profit purpose. Interpretation Bulletin IT-496R (Canada Revenue Agency, 2001) states that it is a question of fact as to whether an organization is carrying on a trade or business and, if so, whether it will result in a finding that an organization is not operated exclusively for nonprofit purposes. The factors that might indicate whether an activity is a trade or business include a) it is a trade or business in the ordinary meaning; that is, it is operated in a normal commercial manner, b) its goods or services are not restricted to members and their guests, c) it is operated on a profit basis rather than a cost-recovery basis, or d) it is operated in competition with taxable entities carrying on the same trade or business. Generally, the carrying on of a trade or business directly attributable to, or connected with, pursuing the nonprofit goals and activities of an organization will not cause it to be considered to be operated for profit purposes (para. 7).

Another source of confusion is that CRA will acknowledge that in the right circumstances an NPO can earn a profit without it being stated that it has a profit purpose. Again, no specific criteria for an acceptable profit-making activity have emerged from case law. CRA (2009) has attempted to interpret the case law, concluding that any profit earned must be unanticipated and incidental. It adds that any profit must be generated from activities that are undertaken to meet the organization's nonprofit purposes (Canada Revenue Agency, 2009). Therefore, the one certain conclusion is that an NPO cannot earn a profit from a distinct activity in order to meet its nonprofit purposes, nor can it adopt a destination-of-funds approach to its operations.

Despite these restrictions, it is quite common for NPOs to earn incidental profits. CRA (2011) also accepts that NPOs can engage in fundraising activities and that such activities generally will not indicate a profit purpose. However, CRA (2011) explains that the fundraising activities must be incidental to the NPO's nonprofit purposes and cannot be a purpose in itself. In other words, an NPO cannot be established for the sole purpose of fundraising to donate proceeds to other not-for-profit organizations.

CRA (2002) recognizes that an NPO can invest in order to generate a profit to fund its activities. However, it indicates that an NPO would be offside the "rules" if it devotes an unreasonable amount of resources to the investment activities, going beyond passive investment (Canada Revenue Agency, 2002). In its interpretation regarding the application of this stipulation to condominium corporations, CRA (2010) notes that income is acceptable in the form of investment income earned on 1) contributed amounts from members that are earmarked for a particular capital project, or 2) reasonable operating reserves derived from member fees or incidental, generally unanticipated, income.

Ambiguity in the rules regarding the business activities of NPOs and mixed case law foster noncompliance. This is compounded by the fact that, unlike the application process for registered charities, there is no initial bottlenecking process to eliminate noncompliant organizations. The federal government's Non-Profit Organization Risk Identification Project (NPORIP) (Canada Revenue Agency, 2013), which documented NPO compliance with several rules, revealed that approximately 40% of sampled NPOs had profits in at least one of the years reviewed and these profits were incidental and related to the nonprofit objectives of the organization, and they did not result in reserves that were unreasonable. The *NPORIP Report* notes that "limited fundraising activities involving games of chance (e.g., lotteries, draws), or sales of donated or inexpensive goods (e.g., bake sales or plant sales, chocolate bar sales), generally do not indicate that the organization as a whole is operating for a profit purpose."

The most common issue identified by the *NPORIP Report* was the number of NPOs that operate for profit, resulting in either an accumulation of unreasonable reserves or personal expenses of members being subsidized by the NPO (Canada Revenue Agency, 2013). Thirty percent of the organizations surveyed were found to be "not operated exclusively for a purpose other than profit," with 14% earning profits of $50,000 or more.

The NPO rules, and in particular the general exemption now found in paragraph 149(1)(l) of the ITA, were arguably adopted to permit commercial risk protection and ease of operation for an organization that has a purpose other than for profit and is not a charity. The consequences of being offside the rules are serious. The organization would be required to file as a taxable entity and could face penalties and interest on prior years if the CRA took the position that the exemption was improperly claimed.

Hybrid Corporations and Business Activities

The ITA is silent on the business activities of hybrid corporations and provides for no special tax treatment for such entities. The income of CICs and C3s is taxed at the rate applicable to all other business corporations. From a tax standpoint, there is no distinction between a hybrid corporation's business revenue and revenue put toward its social goals.

Applying the Rules

Revenue generation is a critical source of alternative funding for charities and NPOs. As can be seen from the rules, however, an NPO or charity cannot generate revenue without obtaining sophisticated advice and doing proper planning. Care must be taken to do so efficiently, effectively, and in a way that ensures compliance. Using several examples, we review the questions organizations must ask when considering the implementation of a revenue-generation regime.

It should be noted that the tax compliance issues are not the only issues to be considered by a charity or NPO when looking at a business activity. Issues such as commercial risk and the desire to work with other partners or raise capital may result in a conclusion that the appropriate structure is a business corporation, trust, or partnership. Such options can be structured in a tax-effective manner, particularly when a charity is involved. Income that would otherwise be subject to tax in such a structure could be tax-exempt if distributed to a charity. If the structure is a corporation, income can be gifted to the charity. If it is a partnership, income flows to the partners to be taxed, and with a trust, provided the income is distributed to the beneficiary before the end of the year, it would be taxed at the beneficiary level. The charity, as beneficiary or partner, is tax-exempt, so no tax is paid. Where the establishment of a business corporation is needed for an NPO project, the issue does not resolve itself as easily. If the NPO earns dividends, partnership, or trust income, it could be argued to be indicative of an intention to make a profit. With the NPO, the profits tend to remain at the commercial activity level as the NPO has a harder time balancing the various issues.

Business Structures for Charities

Generally, a registered charity does not reach a decision to carry on a business and then ask how to do it. In most instances, a charity recognizes that it has a revenue-generating opportunity arising from one aspect of its operations or another. It then, when asking questions about the potential activity, determines that there are legal and regulatory issues to be considered before embarking on the opportunity. It is at this point that the charity must ask whether the activity is in fact a business. If it is, the next question is whether the business is an acceptable related business that can be operated within the registered charity or if it is a prohibited unrelated business. If a conclusion is reached that it is an unrelated business, then consideration of the appropriate structure for that activity is required.

One example is a charity that operates transitional housing. Its purpose is to relieve poverty by providing housing to persons experiencing homelessness. The charity holds property and originally hires a company to manage it but then decides to run the property-management operation itself to reduce its operating expenses. The property-management activity is run by the charity's employees, and volunteers assist with administrative tasks, working out of a room at the charity's main office. The operation is a success, and third parties recognize the charity is managing its own properties well. The charity is asked if it would provide its services to other landowners for a property-management fee at market rates. Is this a business? If so, does it meet the requirements to be a related business?

The first step is to consider whether CRA's four factors suggest that it is a business activity. Is there intention to generate a profit? Potential to show a profit? Existence of profits in past years? What is the expertise and experience of the people or organization undertaking the activity?

The housing charity is engaging in property management to fund the operating expenses for its charitable programs, charging a fee for its services. Because the charity hopes to raise funds, it sets its fees beyond the break-even point of its costs. The activity does not directly benefit the charity's beneficiaries, as the landlord clients of other properties are not users of its charitable programs and services. Further, property management is a service comparable to those otherwise available in the marketplace. Given all these factors, the property-management company is likely a business.

The next question, then, is whether the business is a related or unrelated business. This requires the determination of whether the activity furthers the purposes of the charity as listed in the charity's constating documents. If not, the business is unrelated unless, on the facts, the charity could amend its objects to include a charitable purpose that the activity will support. The property-management activities are not exclusively in furtherance of the organization's charitable purposes. The activity is more of a stand-alone operation than integrated into the charity's operations. This suggests that it is not necessary for the effective operation of the charitable programs. While it may be run out of a spare room at the charity's office, this does not equate to an acceptable use of excess capacity.

What if the housing charity added a new purpose, "to address youth unemployment by providing employment skills training to youth living in transitional housing," and used the property-management company to train youth living in transitional housing for a career in property management? On these facts, the activity would directly further one of the organization's charitable purposes, yet it would still be a business for the reasons outlined above. For it to be a related business, the business activities would need to be subordinate to the charitable purpose of providing employment skills training. If the property-management company existed to provide year-round skills training to youth, then it would likely be a related business. However, if it existed to earn profits for the charity, and simply accepted a few youth interns once in a while, it would likely be an unrelated business.

If the conclusion is reached that it is an unrelated business, the charity could consider several options. CRA (2003, para. 47) explicitly recognizes that a registered charity can establish a *for-profit corporation* and invest in the corporation so long as the investment represents a prudent use of the charity's assets and no private benefit is conferred on the corporation. One example of this structure is a charitable housing corporation with a for-profit subsidiary operating a real estate business. In this arrangement, the for-profit would be subject to tax, but it could donate up to 75% of its annual income to the charity, avoiding significant tax liability. To legally implement this structure, it is crucial that the charity remain separate from the taxable corporation. The charity must ensure that its activities are separate and distinct from those of the for-profit corporation. In this arrangement, any transactions with the for-profit must be for fair market value. Further, the two entities must keep separate books and records. Any intermingling could raise flags and risk revocation of charitable status.

Another option is a *joint project/partnership* between a charity and for-profit business. This is a common arrangement when two entities wish to combine operations to obtain government funding. A common way to structure this joint activity is for the charity and business corporation to incorporate a share capital corporation, each holding 50% of the shares. A charity considering this structure must ensure that any assets or resources transferred to the new share capital corporation, or any services provided, are for fair market value and the cautions noted above continue to apply.

A charity could engage in a business activity through the use of a *subsidiary hybrid corporation*. As with a subsidiary for-profit corporation, the charity retains control of the corporation as a shareholder. The same requirements of fair market value transactions and separate books and records apply to charities with subsidiary hybrid corporations.

A charity can also carry out business activities through the *creation of a trust*. Since a trust is not a legal entity, this arrangement requires creation of a corporation that would act as the trustee of the trust. It is possible to establish multiple business trusts, each holding a different asset in trust for the charity. This separates the risks of one business activity from another. A business trust is taxable at the top marginal rate on all its income. However, income distributed to a beneficiary is taxable in the hands of the beneficiary and not the trust. Thus, if a business trust distributes all profits to a beneficiary that is a charity, the business trust will have no taxable income.

Finally, a charity can hold an interest in a *limited partnership* that has a fair market value of not more than 20% of the fair market value of the interests of all members in the partnership and not be offside the related business rules (ITA, s. 253(2)). There may be certain scenarios where a charity chooses the partnership structure to further its activity.

Business Structures for NPOs

A review of the rules demonstrates that the analysis when considering these issues for an NPO is similar to the analysis when considering the issues for a registered charity. The primary difference is that the charity can generate surpluses when the activity falls into the related business category, whereas the CRA approach to an NPO is that any intention to generate a surplus could put the organization offside. This simply means that, when an NPO is considering its options, it must be careful to structure its activity so that any surplus derives directly from the operations that further its nonprofit purposes and that its planning focuses on sustainability and cost recovery, not generating profit.

Consider an NPO established for the purpose of operating support groups for cancer survivors. The NPO decides to operate a daycare and summer-camp program for the children of cancer survivors to fund its support groups. The daycare and summer program operate during support-group meetings, providing attendees with access to childcare for a fee. However, they also operate outside of meeting hours. Both programs yield high profits.

While these programs were likely created with the best of intentions, they are potentially offside the ITA. The NPO is using profits from the programs to cover the expenses of its support-group program, indicating a profit purpose. The profit is arguably not generated from an activity undertaken to directly meet the organization's nonprofit purposes. Although it can be argued that the daycare operating during support-group meetings is related to the NPO's nonprofit purpose because it makes meetings more accessible for participants with children, the CRA does not accept a "related business" in an NPO as being permitted. In order to operate the daycare, the NPO would have to run the daycare at cost.

To get around the restrictive rules and earn income from a business, NPOs (like charities) can employ various structures and combinations of entities. Just as social innovators and entrepreneurs look to different structures and means of combining entities to achieve social purposes, many charities and NPOs think outside the box, turning to creative structures to further their purposes and access new revenue sources. Because revenue generation by an NPO is more restricted than for a charity, it is more likely to require alternate structures.

As with a charity, an NPO can carry out a business activity in a separate vehicle (such as a share capital corporation or a business trust). This allows the tax-exempt organization to engage in a business activity without having to consider whether it furthers a profit purpose. This structure also protects the organization from liability that could arise from operating the business. Combinations of charities, NPOs, and for-profits can also be used to carry out business activities. Mixed-use housing projects serve as an illustrative example. A charity offering housing for people with disabilities and an NPO offering below-market housing can join with a for-profit developer to develop housing that provides for residential, commercial, and institutional uses.

Alternative Regimes

Sharing its origins with England, New Zealand, and Australia, Canadian charity law stems from the United Kingdom's Statute of Charitable Uses Act of 1601, also known as the Statute of Elizabeth, as well as the seminal decision of *Commissioners for Special Purposes of the Income Tax v Pemsel* (1891). Despite this shared origin, Canada does not take the same approach as these countries to the regulation of the business activities of tax-exempt organizations. Legislative developments and case law in Australia, New Zealand, England, and the United States have affected the law in this area, providing in some instances charities with access to much-needed revenue. Some jurisdictions have always provided charities with the flexibility to engage in business, while others have eliminated outdated restrictions on business activities.

The destination-of-funds test has been endorsed by two Commonwealth jurisdictions – Australia and New Zealand. The Australian High Court has accepted this test, permitting charities to engage in business activities so long as profits are put toward charitable ends. In the case of *Commissioner of Taxation of the Commonwealth of Australia v Word Investments Ltd*. (2008), several members of a Christian missionary charity founded Word Investments Ltd. to raise money for the charity. Word Investments gave its profits to the charity and other Christian organizations, but it did not engage in any missionary activities itself: its only activities were operating an investment fund and a funeral home. At the time, it was the view of the Australian Taxation Office that a charity could engage only in commercial activities that were ancillary and incidental to the entity's charitable purposes (Australian Taxation Office, 2005, para. 20). The court rejected this view, however, holding that:

> Word endeavoured to make a profit, but only in aid of its charitable purposes. To point to the goal of profit and isolate it as the relevant purpose is to create a false dichotomy between characterisation of an institution as commercial and characterisation of it as charitable. (*Commissioner of Taxation for the Commonwealth of Australia v Word Investments Limited, 2008*, para. 24)

The court rightly concluded that the raising of funds in a commercial manner to further a charitable purpose should not preclude an organization from being a charitable institution. What defines an entity as "charitable" is not whether it raises money by commercial means, but whether the money raised is ultimately put toward a charitable cause or charitable organization. New Zealand's position on the business activities of charities follows the decision of the High Court of Australia in *Word Investments*. A charity can carry on a business activity if the business's income is applied to charitable purposes (*Auckland Medical Aid Trust v Commissioner of Inland Revenue*, 1979; *Commissioner of Inland Revenue v Carey's (Petone and Miramar) Ltd*, 1963; *Commissioner of Inland Revenue v MTN Bearing-Saeco (NZ) Ltd*, 1986).

England takes a slightly different, more restrictive approach. English charities can engage in "primary purpose trading," which allows them to operate commercial activities to raise funds in furtherance of their charitable purposes (Charity Commission for England and Wales, 2014). However, unlike Canadian charities, English charities can operate businesses unrelated to their charitable purposes. While proceeds of primary-purpose trading are tax-free, income from non-primary-purpose trading (i.e., an unrelated business) is typically taxed, even where the profits are used to further charitable purposes (Charity Commission for England and Wales, 2014). If a business activity does not relate to the charity's primary purpose, it may still be exempt from tax if its gross annual income is below a certain threshold. English charities can also establish "subsidiary trading companies" (Charity Commission for England and Wales, 2014). These entities can be used to earn income that is not linked to the charity's primary purposes, and they protect the assets of the charity from any business losses. Indeed, the Charities Commission for England and Wales mandates the use of such trading companies where trading involves significant risk to a charity's assets (Charity Commission for England and Wales, 2016). While trading subsidiaries pay corporation tax like other for-profit companies, a trading subsidiary can return all its profits to its parent charity, excluding those profits from tax payable (Charity Commission for England and Wales, 2016).

The US law regulating the business activities of tax-exempt organizations combines aspects of Canadian and English law. US charities may operate businesses that are substantially related to their charitable purposes (26 USC §512). Charities that engage in business activities unrelated to their charitable purposes may be subject to tax on the income from these activities. If the unrelated business activity becomes "substantial," the charity may lose its status.[9] This tax was introduced to ensure fair competition between tax-exempt organizations and taxable companies (Internal Revenue Service, 2001: 2). US courts have relied on the "commerciality doctrine" to determine whether a charity engaging in commercial activities is operating primarily for tax-exempt purposes (*Better Business Bureau of Washington, D.C., Inc. v United States*, 1945). The doctrine holds that a charity may engage in activities of a commercial nature so long as profit does not become the primary pursuit of the organization (Brennan, 2002: 848). Whether a charity is entitled to tax-exempt status "turns largely on whether its activities are conducted primarily for a commercial or for an exempt purpose (*Airlie Foundation v Internal Revenue Service*, 2003).

Policy Options

The related business rules for registered charities were introduced to permit Canadian registered charities to generate revenues in situations where the common law of charity would have objected to the activity. These rules have permitted registered charities like the YMCAs across the country to operate and fund charitable programming. Some authors argue that the current rules, for registered charities at least, have worked quite well and question if there is a need for reform (Drache, Stevens, & Hayhoe, 2007). Others question the need for a nonprofit tax-exempt category at all. The reality is that confusion is at a level that reform is necessary. The question is, what reform should Canada adopt?

Destination of Funds

The adoption of the destination-of-funds test originally accepted by the courts in *Alberta Institute on Mental Retardation v The Queen* (1988) for both registered charities and NPOs would be welcome. When considering this strictly from the public-benefit NPO or registered charity perspective, the experiences in Australia and other common law jurisdictions in accepting the destination-of-funds test support the adoption of such a regime in Canada. If an organization can successfully generate revenue that will be used to further its charitable mission, why would the regulator not want to enable that result? Permitting organizations to become more self-sustaining is generally thought to be an attractive way forward.

The biggest hurdle to this idea in Canada seems to be the notion of the unlevel playing field and the possibility that such an environment would prefer the voluntary sector organizations over private ones. Businesses argue they would be prejudiced if the system permits these activities in tax-exempt organizations. This argument can be challenged on many levels, however. First, tax-exempt organizations are severely restricted in how they raise capital. For-profit entities are much more capable of pursuing economic activity and generating wealth and are provided with many benefits in the tax system for doing so. Second, there is no evidence that the activity of a charity or NPO creates unfair competition. Generally, the charity or NPO wants to generate as much revenue as possible from the activity that supports charging the same fees as others in the market. Finally, it is usually the case that the charity or NPO is operating a business-like activity coincident with fulfilling their nonprofit purpose. The activity should not be directly compared to the for-profit activity as it will have attributes that distinguish it and support the different treatment.

From a policy perspective, it can be argued that the critical distinction between these types of entities is that a charity or NPO generates revenue to further its objective, whereas for-profit entities are structured to generate wealth for owners. When considering how charities and NPOs can operate and whether business activity can appropriately be pursued, this key distinction should not be forgotten. The tax system insists on taxing the surpluses that will eventually increase the wealth and personal position of others. It does not tax surpluses that are intended to be applied to a purpose other than profit. That policy framework makes sense – if it works. Unfortunately, lawmakers have lost sight of that framework when applying the rules today.

At a time when government funding is under significant pressure and fundraising may be curtailed, the adoption of a destination-of-funds approach to revenue generation should be considered. The current rules do in some situations cause charities and NPOs to step back and refrain from providing services that could otherwise be supported.

Unrelated Business Income Tax

Would we want Canada to implement an "unrelated business income tax" as in the US? The allocation of revenues and expenses within this approach can be just as complex and unwieldy as the rules that exist today in Canada. On its annual return Form 990-T, a US tax-exempt organization must classify its activities as exempt or taxable and allocate revenues and expenses between exempt and taxable activities. Identifying both the revenue from an unrelated business and the directly connected expenses that are allowable as deductions is no easy task. Determining whether a source of income is unrelated business income (UBI) requires a three-part test involving an assessment of whether the income-generating activity is 1) a trade or business, 2) not substantially related to the organization's tax-exempt purposes, and 3) regularly carried on by the organization. Because the answers to these questions are not always clear, organizations risk under- or over-reporting UBI. It is certainly not clear that such a system would improve the ability of the voluntary sector to generate revenue. In fact, determining what would be considered to be in or out of the calculations would, in effect, be the same exercise charities and nonprofits embark on now. Agreeing to a UBI tax would likely mean that revenues currently earned as tax-exempt would become taxable. It is difficult to see how it would simplify the structures or improve the ability of charities and NPOs to raise revenues to further their purposes.

Hybrid Corporations

Another policy question is should the rules be revamped to somehow enhance the use of hybrid corporations for the sector? Would federal hybrid legislation provide a solution to the business restrictions on charities and NPOs? Some sector advocates do not think so. In particular, ONN (a group of approximately 60,000 NPOs across Ontario) has advised against modifications to the Canada Business Corporations Act to provide for hybrid corporations (ONN, 2015: 2). ONN (2015: 6) is highly critical of dual-purpose legislation, arguing that it is too complex and fails to ensure accountability to the public. Instead, ONN (2015: 8) advocates for increased flexibility for non-share capital corporations to earn revenue, so long as profits are used for activities that support their nonprofit goals. In other words, an appropriate destination-of-funds test should work.

While hybrid structures can be quite complex and onerous to operate, tax reductions may make them worthwhile for entrepreneurs and investors. With the right incentives in place, hybrid corporations can contribute to social innovation, providing the dual advantages of non-share capital corporations and for-profits. Such a result seems attractive, but wait: again, private sector for-profit advocates have complained about what they characterize as an encroachment on the "business" world by organizations that have tax-preferred status.

Which Policy Way Forward?

Upon reviewing the rules and various structures required for charities and NPOs to engage in business, it is clear that Canada requires a more refined and less restrictive system for regulating business activities. Case law and CRA policy have resulted in confusion and uncertainty. This uncertainty severely restricts charities' and NPOs' abilities to engage in business activities. Without a definitive test for whether an activity qualifies as a related business or furthers a profit purpose, there is no guarantee as to how an activity will be characterized by CRA. This uncertainty leads to a chilling effect, stifling innovation.

While certain structures can be legally employed to carry out business activities, they take time and financial resources to implement. The destination-of-funds test, adopted in Australia and New Zealand, would provide Canada's charitable and nonprofit sector with new and innovative ways to generate revenue. Implementation of the destination-of-funds test would not jeopardize the tax base but would permit public-benefit organizations to become more self-sustaining and productive in the future. Acceptance of this test would avoid the implementation of tax on unrelated business income, the approach taken by England and the United States. The unrelated-business tax, aimed at curtailing competition between tax-exempt organizations and for-profits, does not address the reality that charities and NPOs do business not to compete, but to survive.

Conclusion

We have examined the differences between charities and NPOs and how each entity is affected by restrictions on business activities. We surveyed how the business activities of tax-exempt organizations are regulated in different jurisdictions, arguing that outdated Canadian laws fail to meet the needs of charities and NPOs. Not only is Canada's system restrictive and ambiguous, it comes with harsh penalties. Failure to follow the rules can be grounds for financial penalties or revocation of charitable registration. NPOs risk losing their status and being assessed on taxable income.

While the creation of separate entities can be highly effective in enabling a tax-exempt organization to indirectly carry out activities that can both further its purpose and generate revenue, this is a costly and time-consuming solution. Further, if organizations do not employ these structures legally, they can face serious consequences. The adoption of the destination-of-funds test in Canada would be a boon to the nonprofit sector, avoiding the need to engage complex structures in most circumstances. In addition, organizations would be less reliant on traditional, yet increasingly scarce, funding sources. Now more than ever, charities and NPOs stand to benefit from reforms that would not only help them stay afloat, but help them thrive.

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Notes

[1] Also called the "destination of profits" test.

[2] Section 149 of the ITA lists many types of tax-exempt organizations, ranging from research and development entities to municipalities, all of which are tax-exempt, assuming they meet specific requirements and many of which are subject to their own specific rules.

[3] A charitable organization can also be formed as a trust or an association. An NPO can also be formed as a society.

[4] "Qualified entities" include community service cooperatives, registered charities, and other qualified donees, as defined in the Income Tax Act (Canada).

[5] "Qualified entities" include nonprofit associations within the meaning of Section 61A of the Co-operative Associations Act (NS), registered charities, societies incorporated under the Societies Act (NS), and certain *prescribed entities* – defined in the regulations.

[6] CRA states that a private benefit is acceptable if it is incidental to the pursuit of a charitable purpose (Canada Revenue Agency, 2006, s. 3.2.4)

[7] Gifts-in-kind are non-cash gifts such as real estate, equipment, or household items.

[8] Case law has held that the retention of excess funds will not, in and of itself, put an NPO offside the ITA (See *BBM Canada v Minister of National Revenue,* 2008).

[9] An "insubstantial part" of the charity's activities may be in furtherance of non-exempt purposes. (See 26 CFR § 1.501(c)I(3)-1(b)(1)(i)(b)).

Biography

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Susan Manwaring is the national lead of Miller Thomson's Social Impact Group, providing both general counsel and specialized tax advice to social enterprises, charities, and nonprofits across Canada and internationally. She advises foundations in the field of mission investing and social finance and counsels charities and nonprofit organizations on compliance and taxation matters and relevant provincial tax regulations. Susan was a member of the CRA Consultation Panel on the Political Activities of Charities. She is currently a member of the Advisory Committee on the Charitable Sector (ACCS) – a ministerial committee advising the Minister of National Revenue. Susan has been recognized extensively for her expertise and participates widely in sector activities, including many public policy discussions related to the regulation of the charity and nonprofit sectors.

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