

How do charitable organizations and foundations differ under income tax?

With the introduction of the “control” test, it is important to carefully review these rules when establishing charitable organizations and public foundations involving a major donor to ensure that the charity in question will not inadvertently be deemed to be a private foundation.

By **Theresa L.M. Man and Terrance S. Carter**

This article provides an overview of the differences between charitable organizations, public foundations and private foundations and their requirements under the *Income Tax Act* (Canada) (the “Act”). As a result of recent proposed amendments to the defi-

nitions of charitable organizations and public foundations, as well as the recently amended disbursement quota rules that apply to them, there will be little functional difference between charitable organizations and public foundations.

Relationship between directors and control

For charitable organizations and public foundations, the Act currently provides that more than 50 per cent of directors or trustees must deal with each other at arm’s length, and not more than 50 per cent of the capital may be contributed by one person or a group who do not deal with each other at arm’s length.

Due to requests from the public, the definitions of charitable organizations and public foundations are proposed to be amended to permit a donor to contribute more than 50 per cent of the charity’s capital as long as the donor does not control the charity or represent more than 50 per cent of the directors or trustees of the charity. With the introduction of this “control” test, it is important to carefully review these rules when establishing charitable organizations and public foundations involving a major donor to ensure that the charity in question will not inadvertently be deemed to be a private foundation. These amendments, which were first proposed on Dec. 20, 2002, and revised on Feb. 27, 2004, and again on July 18, once enacted, will become generally retroactive to Jan. 1, 2000.

The definition of private foundations remains unchanged, i.e. it is not a requirement that more than 50 per cent of the directors or trustees of a private foundation be at arm’s length, and it is not a requirement that not more than 50

per cent of funds received be from one donor or donors who are at arm’s length.

Disbursement quota rules

New disbursement rules enacted on May 13, by way of the *Budget Implementation Act, 2004, No. 2* are now the same for charitable organizations and public foundations, subject to some transitional provisions. The new rules generally apply to registered charities retroactive to March 23, 2004. Charitable organizations and public foundations are generally required to expend 80 per cent of gifts received, gifts received from other charities in the immediately preceding year, and enduring property expended in the year, as well as 100 per cent of enduring property transferred to qualified donees in the year. They are also required to expend at least 3.5 per cent of assets over \$25,000 that are not used directly in charitable activities or administration. New rules regarding encroachment on the capital gains pool of enduring property to satisfy the 3.5 per cent disbursement quota have also been enacted.

The disbursement quota rules for private foundations are very similar to those for charitable organizations and public foundations, save and except that private foundations must expend 100 per cent (rather than 80 per cent) of all amounts received from other registered charities in the immediately preceding taxation year, other than specified gifts and enduring property.

Related business

Charitable organizations and public foundations can carry on related businesses. Private foundations, however, may not carry on any business activity.

Charitable activities

Charitable organizations primarily carry on their own charitable activities. They may give less than 50 per cent of their income annually to other qualified donees, unless they are associated charities.

For public foundations, since paragraph 149.1(6)(b) of the Act provides that charitable organizations may not disburse more than 50 per cent of their income annually to qualified donees, and since the definition for “charitable foundation” in the Act provides that a charitable foundation is “not a charitable organization,” Canada Revenue Agency (“CRA”) takes the administrative position that public foundations must disburse at least 50 per cent of their income to qualified donees.

For private foundations, CRA takes the administrative position that the definition in the Act of a “private foundation” as a charitable foundation that is *not* a

public foundation means that private foundations are not required to give at least 50 per cent of their income annually to other qualified donees.

Legal structure

Charitable organizations can be organized either as corporations, unincorporated associations established by constitution or charitable trusts. Foundations, however, must either be corporations or trusts.

Borrowing

Foundations are prohibited from incurring debts other than debts for current operating expenses, the purchase and sale of investments, or the administration of the charitable activities. However, these restrictions do not apply to charitable organizations.

Control of other corporations

Foundations are prohibited from acquiring control of any corporation. Failure to comply with this restriction may lead to the revocation of their charitable status. Generally, control occurs when a foundation owns 50 per cent or more of a corporation’s issued share capital, having full voting rights under all circumstances. However, a foundation that has not bought more than 5 per cent of these shares but is given a bloc of shares that brings up its total holding to more than 50 per cent will not be considered to have acquired control of the corporation. The restrictions that apply to foundations do not apply to charitable organizations.

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