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Introduction

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”).¹ As a result of recent proposed amendments concerning the definitions 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. To facilitate comparison, a table has been included that may serve as a useful tool in assisting the charitable sector and charity law practitioners to better understand these differences.

Summary of the Differences Between the Three Categories of Registered Charities

1. *Relationship Between Directors/Trustees and Control*²

The Act currently provides that more than 50% of the directors or trustees of charitable organizations and public foundations must deal with each other and with each of the other directors or trustees at arm’s length. The Act also currently requires that not more than 50% of the capital contributed or otherwise paid to a charitable organization or public foundation be contributed by one person or members of a group of persons who do not deal with each other at arm’s length, save and except some organizations, i.e., the federal government, provincial governments, municipalities, other registered charities that are not private foundations, and nonprofit organizations. This is usually referred to as the “contribution test.”

As a result of inquiries from the public, the Department of Finance proposed to amend the definition of both charitable organizations and public foundations in order to ensure that in certain circumstances large donations are not prohibited. It proposed to do this by replacing the “contribution test” with a “control test” in subsection 149.1(1) of the Act, which would make it permissible for a person, or a group of persons not dealing with each other at arm’s length, to contribute more than 50% of the charity’s capital as long as such a person or group does not control the charity in any way or represent more than 50% of the directors, trustees, officers, and similar officials of the charity.

The rationale for amending the definitions is to permit charitable organizations and public foundations to receive large gifts from donors without concern that they may be deemed to be private foundations by virtue of such gifts. However, funds received from the federal government, provincial governments, municipalities, other registered charities that are not private foundations, and nonprofit organizations are not subject to the “control test.” As a result, in relation to the application of the control test and the contribution test, there is no difference between charitable organizations and public foundations.

These amendments were first introduced as part of draft technical amendments to the Act released on December 20, 2002 (the “December 2002 Amendments”).³ Those changes were included in the revised draft technical amendments released by the Minister of Finance on February 27, 2004 (the “February 2004 Amendments”),⁴ with the addition of minor wording in subparagraph (d)(ii) of both definitions for clarification. The wording of the proposed amendment is further revised in a package of draft technical amendments released by the Department of Finance on July 18, 2005.⁵ These changes are summarized in row (1) of Table 1. These amendments have not been introduced in Parliament for enactment. However, once enacted, these amendments will become generally retroactive to January 1, 2000.

There is no change to the current definition of private foundation, i.e., it is not a requirement that more than 50% of the directors, trustees, and officers of a private foundation must be at arm’s length, and it is not a requirement that not more than 50% of the funds a private foundation receives must come from one donor or donors who are at arm’s length.

Under the proposed rules, when applying the “control test,” some registered charities may find that they no longer fit under their current designation. Registered charities that wish to apply under subsection 149.1(6.3) to change their designation as a result of the amendments described above will be required to apply within 90 days of the date when the July 2005 Amendments receive Royal Assent. These registered charities will then be deemed to be registered as charitable organizations, public foundations, or private foundations, as the case may be, in the taxation year that the Minister specifies.

As a result of the introduction of a “control test,” the convoluted rules under the Act in relation to “control” will become applicable, specifically due to the inclusion of the phrase “controlled directly or indirectly in any manner whatever” in the new definitions. However, the application of the rules concerning “control” in the charitable context is unclear, since these rules are premised upon application to commercial arrangements in a business context rather than for registered charities. As such, charity law practitioners will need to carefully review these rules when establishing charitable organizations and public foundations involving a major donor who contributes

more than 50% of the capital for a charity, especially in the case of establishing a multiple corporate structure, in order to ensure that the charity in question will not inadvertently be caught by these rules that might otherwise lead to the unintended result of a charity being deemed a private foundation. As well, the current relationship of multiple corporate structures should also be reviewed in order to assess whether this new control test may have an undesirable effect.

2. *Disbursement Quota Rules*⁶

Changes to the disbursement quota rules were introduced in the 2004 Federal Budget released on March 23, 2004, by the Department of Finance. Draft amendments to the Act were released on September 16, 2004, and were further amended by a Notice of Ways and Means Motion tabled by the Minister of Finance in the House of Commons on December 6, 2004 (the “December 2004 Amendments”). The December 2004 Amendments were introduced in Parliament as Bill C-33, *A Second Act to Implement Certain Provisions of the Budget Tabled in Parliament on March 23, 2004*, and were enacted on May 13, 2005, as the *Budget Implementation Act, 2004, No. 2*.⁷

Prior to the *Budget Implementation Act, 2004, No. 2*, the disbursement quota rules for charitable organizations and public foundations were significantly different. However, as explained above, the new disbursement quota rules contained in the *Budget Implementation Act, 2004, No. 2*, generally apply to registered charities effective retroactively as of March 23, 2004, so that the disbursement quota rules for charitable organizations and public foundations are now the same, subject to some transitional provisions.

Details regarding the new rules have been summarized in an article, “New Disbursement Quota Rules under Bill C-33,” by Theresa L.M. Man and M. Elena Hoffstein.⁸ Please refer to that article for a detailed explanation of the new disbursement quota rules. For purposes of this article, the main features of the new disbursement quota rules are summarized below:

- The disbursement formula is $A + A.1 + B + B.1$.
- 80% disbursement quota: The 80% disbursement quota is equal to (1) 80% of gifts received in the immediately preceding year (except gifts of enduring property and gifts received from other registered charities), plus (2) 80% of enduring property expended in the year and 100% of enduring property transferred to qualified donees in the year, less the optional reduction by the amount of realized capital gains on enduring property, plus (3) 80% of gifts received from other charities in the immediately preceding year (except property that was received as a specified gift or as enduring property).
- 3.5% disbursement quota: In addition to the 80% disbursement quota requirement, registered charities are also required to expend at least

3.5% of their assets that are not used directly in their charitable activities or administration.⁹ The value of the assets in this regard is based on the average value of the registered charities' assets that are not used directly in charitable activities or administration in the 24 months immediately preceding the taxation year. The 3.5% disbursement quota does not apply where the amount of property owned by the charity in this regard is \$25,000 or less.

- New rules regarding the encroachment on capital gains pool of enduring property to satisfy the 3.5% disbursement quota have also been enacted.

The disbursement quota rules for private foundations are very similar to those for charitable organizations and public foundations, except that private foundations must expend 100% (rather than 80%) of all amounts received from other registered charities in the immediately preceding taxation year, other than specified gifts and enduring property when calculating variable B and B.1 in the disbursement quota formula.

3. *Related Business*¹⁰

Charitable organizations¹¹ and public foundations can carry on related businesses.¹² If charitable organizations and public foundations carry on unrelated businesses, their charitable status may be revoked.¹³ Private foundations, however, may not carry on any business activity; if they do, their charitable status may be revoked.¹⁴

4. *Charitable Activities*¹⁵

Charitable organizations primarily carry on their own charitable activities. They may give funds to other qualified donees but may not disburse more than 50% of their income annually to qualified donees,¹⁶ unless they are associated charities.¹⁷

Public foundations, however, must give more than 50% of their income annually to other qualified donees.¹⁸ However, this requirement is not explicitly set out in the Act. Paragraph 149.1(6)(b) of the Act provides that charitable organizations may not disburse more than 50% of their income annually to qualified donees. The definition for “charitable foundation” in subsection 149.1(1) of the Act provides that a charitable foundation is “not a charitable organization.” As such, Canada Revenue Agency (“CRA”) takes the administrative position that the language in the definition for “charitable foundation” would mean that public foundations must disburse at least 50% of their income to qualified donees.

Private foundations may carry on their own charitable activities, and may give funds to other qualified donees. It is not clear from the Act whether there is any requirement on private foundations to give more than 50% of their income annually to other qualified donees. As explained above, CRA takes the admin-

istrative position that the language in the definition for “charitable foundation” implies that public foundations must disburse at least 50% of their income to qualified donees. CRA also takes the administrative position that the definition for “private foundation” in subsection 149.1(1) of the Act indicating that a private foundation is a charitable foundation that is *not* a public foundation means that private foundations are not required to give at least 50% of their income annually to other qualified donees.

5. *Legal Structure*¹⁹

The definition for “charitable organization” indicates that it is an organization that may either be incorporated or unincorporated.²⁰ As such, charitable organizations can be organized either as corporations, unincorporated associations established by constitution, or charitable trusts.²¹ The definition for “charitable foundation”²² indicates that public and private foundations must either be corporations or trusts.

6. *Borrowing*²³

Public and private foundations are prohibited from incurring debts other than debts for current operating expenses, the purchase and sale of investments, or the administration of charitable activities.²⁴ However, these restrictions that apply to public and private foundations do not apply to charitable organizations.

7. *Control of Other Corporations*²⁵

Public and private foundations are prohibited from acquiring control of any corporation.²⁶ Failure to comply with this restriction may lead to the revocation of their charitable status. Generally, control occurs when the foundation owns 50% or more of a corporation’s issued share capital, having full voting rights under all circumstances.²⁷ However, a foundation that has not bought more than 5% of these shares but is given a bloc of shares that brings up its total holding to more than 50% will not be considered to have acquired control of the corporation.²⁸

The restrictions that apply to foundations do not apply to charitable organizations. This means that, for purposes of the Act, charitable organizations are permitted to acquire control of a corporation. As such, CRA suggested that a charitable organization may operate a business through a taxable share capital corporation with the charitable organization retaining control over the taxable corporation “through share holdings or a power to nominate the board of directors.”²⁹ However, this option is not available to charities in Ontario as a result of the application of the *Charitable Gifts Act* (Ontario).³⁰

Table 1. Differences Between Charitable Organizations, Public Foundations, and Private Foundations

Characteristics	Types of Registered Charities	
	Charitable Organizations	Public Foundations
(1) Relationship between directors/trustees and control	<p>The Act currently provides that more than 50% of the directors or trustees of charitable organizations and public foundations must deal with each other and with each of the other directors or trustees at arm's length. The Act also currently requires that not more than 50% of the capital contributed or otherwise paid to a charitable organization or public foundation be contributed by one person or members of a group of such persons who do not deal with each other at arm's length, save and except some organizations, i.e., the federal government, a provincial government, a municipality, other registered charities that are not private foundations, and nonprofit organizations. This is usually referred to as the "contribution" test.</p> <p>But an amendment to the Act has been proposed that would replace the "contribution test" with a "control test" in subsection 149.1(1) of the Act, which would make it be permissible for a person, or a group of persons not dealing with each other at arm's length, to contribute more than 50% of the charity's capital as long as such a person or group does not control the charity in any way or represent more than 50% of the directors, trustees, officers, and similar officials of the charity. In general, this new definition is retroactively applicable to January 1, 2000.</p>	<p>It is not a requirement that more than 50% of the directors/ trustees/ officers of a private foundation must be at arm's length, and it is not a requirement that not more than 50% of the funds a private foundation receives comes from one donor or donors who are at arm's length.</p>
(2) Disbursement quota rules	<p>Prior to the <i>Budget Implementation Act, 2004, No. 2</i>, the disbursement quota rules for charitable organizations and public foundations were different.</p> <p>However, the Act is now amended by the <i>Budget Implementation Act, 2004, No. 2</i>, effective retroactively as of March 23, 2004, so that the disbursement quota rules for charitable organizations and public foundations are now the same, subject to a transitional period for charitable organizations registered before March 23, 2004, in that the 3.5% disbursement quota will apply to their taxation years that begin after 2008. To summarize:</p> <ul style="list-style-type: none"> • the disbursement quota is $A + A.1 + B + B.1$ • 80% disbursement quota • 3.5% disbursement quota; and • possible encroachment on capital gains pool of enduring property to satisfy the 3.5% disbursement quota. 	<p>The disbursement quota rules for private foundations are very similar to those for charitable organizations and public foundations, except that private foundations must expend 100% (rather than 80%) of all amounts received from other registered charities in the immediately preceding taxation year, other than specified gifts and enduring property when calculating variable B and B.1 in the disbursement quota formula.</p>

Types of Registered Charities		
Characteristics	Charitable Organizations	Private Foundations
(3) Related business	Can only carry on related businesses.	Cannot carry on any business.
(4) Charitable activities	Charitable organizations primarily carry on their own charitable activities, may give funds to other qualified donees, and may not disburse more than 50% of their income annually to qualified donees, unless they are associated charities.	Private foundations may carry on their own charitable activities, and CRA takes the administrative position that there is no requirement on private foundations to give more than 50% of their income annually to other qualified donees.
(5) Legal structure	Charitable organizations must be corporations, unincorporated associations or charitable trusts.	Public and private foundations must be either corporations or trusts.
(6) Borrowing	The restrictions that apply to public and private foundations do not apply to charitable organizations.	Public and private foundations cannot incur debts other than debts for current operating expenses, the purchase and sale of investments, or the administration of the charitable activities.
(7) Control of other corporations	No restriction	Public and private foundations cannot acquire control of any corporation. Generally, control occurs when the foundation owns 50% or more of a corporation's issued share capital, having full voting rights under all circumstances. However, the Act permits an exception: where the foundation has not bought more than 5% of these shares and is given a bloc of shares that brings up its total holding to more than 50%, it will not be considered to have acquired control of the corporation.
<p>Notes to Table 1</p> <p>For issues listed in rows (1), (2), and (3), the rules for charitable organizations and public foundations are the same, but different for private foundations.</p> <p>For the issue listed in row (4), the rules are different for each of the three categories of registered charities.</p> <p>For issues listed in rows (5), (6), and (7), the rules for public foundations and private foundations are the same, but different for charitable organizations.</p>		

Conclusion

As a result of these new changes, there will be little functional difference between charitable organizations and public foundations. The key remaining differences appear to be that (i) a charitable organization is prohibited from disbursing more than 50% of its annual income to qualified donees and (ii) foundations are restricted in their ability to incur debt. It would therefore not be surprising if the Department of Finance, as a matter of policy, eventually eliminates the distinction between charitable organizations and public foundations altogether so that there would be only two remaining categories of charities, i.e., charities and private foundations. It will be interesting to see what transpires in this regard over the next few years.

NOTES

1. R.S.C. 1985, c. 1 (5th Supp.).
2. See row (1) in Table 1.
3. Details regarding the December 2002 Amendments have been summarized in *Charity Law Bulletin* No. 21 dated April 30, 2003, available at <www.charitylaw.ca>.
4. Copies of the Legislative Proposals, Draft Regulations and Explanatory notes are available at: <<http://www.fin.gc.ca/toce/2004/ita04-introe.html>> and have been summarized in *Charity Law Bulletin* No. 40 dated March 29, 2004, available at <www.charitylaw.ca>.
5. Details regarding the changes proposed by the draft technical amendments released by the Department of Finance on July 18, 2005 (the “July 2005 Amendments”), and the differences between these proposed amendments and the proposed changes released on February 27, 2004, will be summarized in a future *Charity Law Bulletin*.
6. See row (2) in Table 1.
7. R.S.C., 2004, c. 19.
8. See article “New Disbursement Quota Rules under Bill C-33” by Theresa L.M. Man and M. Elena Hoffstein, paper presented at the Canadian Bar Association/Ontario Bar Association 3rd National Symposium on Charity Law, May 6, 2005 for details, available at <www.charitylaw.ca>. See also *Charity Law Bulletin* Nos. 59, 61, 67, and 69, also available at <www.charitylaw.ca>.
9. The reduced 3.5% disbursement quota applies to public and private foundations for taxation years beginning after March 22, 2004. For charitable organizations registered before March 23, 2004, the 3.5% disbursement quota applies to their taxation years that begin after 2008. For charitable organizations registered after March 22, 2004, the 3.5% disbursement quota applies to their taxation years that begin after March 22, 2004. The detailed method for the calculation of the 3.5% disbursement quota is set out in Regulation 3700, 3701, and 3702 of the *Income Tax Regulations*.
10. See row (3) in Table 1.
11. Paragraph 149.1(6)(a) of the Act.
12. See Canada Revenue Agency Policy Statement CPS – 019 entitled “What is a Related Business?” dated March 31, 2003.
13. Paragraphs 149.1(2)(a) and 149.1(3)(a) of the Act.

14. Paragraph 149.1(4)(a) of the Act.
15. See row (4) in Table 1.
16. Paragraph 149.1(6)(b) of the Act.
17. Paragraph 149.1(6)(c) of the Act.
18. Subsection 149.1(1) of the Act provides that qualified donees are organizations that can issue official donation receipts for gifts that individuals and corporations make to them under paragraphs 110.1(1)(a) and (b) and 118.1(1). They consist of registered charities in Canada, registered Canadian amateur athletic associations; housing corporations resident in Canada constituted exclusively to provide low-cost housing for the aged; Canadian municipalities; the United Nations and its agencies; universities that are outside Canada that are prescribed to be universities the student body of which ordinarily includes students from Canada; charitable organizations outside Canada to which Her Majesty in right of Canada has made a gift during the fiscal period or in the 12 months immediately preceding the period; and Her Majesty in right of Canada or a province. In February 2004, it was proposed to amend sections 110.1 and 118.1 of the Act by expanding the list of qualified donees to include municipal or public bodies performing a function of government in Canada.
19. See row (5) in Table 1.
20. See the definition for “charitable organization” in paragraph 149.1(1) of the Act.
21. See CRA publication entitled “Registering a Charity for Income Tax Purposes” T4063.
22. See the definition for “charitable foundation” in paragraph 149.1(1) of the Act.
23. See row (6) in Table 1.
24. Paragraph 149.1(3)(d) and 149.1(4)(d) of the Act.
25. See row (7) in Table 1.
26. Paragraphs 149.1(3)(c) and 149.1(4)(c) of the Act.
27. Paragraph 149.1(12)(a) of the Act.
28. *Ibid.*
29. See CRA Policy Statement CPS – 019 entitled “What is a Related Business?” dated March 31, 2003 at paragraphs 47 and 48.
30. Section 2(1) of the *Charitable Gifts Act* (Ontario) R.S.O. 1990, c. C.8 provides that a charity is not permitted to own more than ten percent (10%) of an “interest in a business that is carried on for gain or profit is given to or vested in a person in any capacity for any religious, charitable, educational or public purpose.” A charity, however, is permitted to invest in a business as a minority owner, provided that it does not “own,” either directly or indirectly, an interest in excess of 10%. If the charity is found to own more than 10% of an interest of a business, it would have to dispose of any interest in excess of 10% within seven years, although it might be possible to obtain a court order to extend the seven-year period.