

Charitable Organizations and Public Foundations: The Need for Re-categorization

A Paper

By

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By Theresa L.M. Man*

Abstract

There are three types of registered charities, namely charitable organizations, public foundations and private foundations under the *Income Tax Act* (Canada), each of which are separately defined and regulated. Due to the implementation of the same disbursement quota rules for charitable organizations and public foundations on May 13, 2005, one of the key differences between these two categories of charities was removed. This paper reviews the differences between charitable organizations and public foundations under the Act, traces the tax policy behind the historical development of these differences, and proposes to combine these two categories of registered charities into one in order to achieve a simpler and more efficient regime for the regulation of charities.

A. Introduction

Under the *Income Tax Act* (Canada) (the “Act”),¹ there are three types of registered charities, namely charitable organizations, public foundations and private foundations. Each of these categories of charities are separately defined and regulated under the Act.

The Ontario Law Reform Commission (the “OLRC”) recommended in its report (the “OLRC Report”) in 1996 that the Act “should continue to use the basic classifications ‘public’ and ‘private’ ‘foundations’ and ‘charitable organizations.’”² However, since 1996, a number of changes have been made to the Act affecting charities. One of the most significant changes is the application of the same disbursement quota requirements for both charitable organizations and public foundations as a result of the enactment of Bill C-33, *A Second Act to Implement Certain Provisions of the Budget Tabled in Parliament on March 23, 2004* on May 13, 2005, as the

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¹ R.S.C. 1985, c. 1 (5th Supp.), as amended (hereinafter referred to as the “Act”).

² Ontario Law Reform Commission, *Report of the Law of Charities* (Toronto: Ontario Law Reform Commission, 1996) at 630 (hereinafter referred to as the “OLRC Report”).

Budget Implementation Act, 2004, No. 2 (“Bill C-33”),³ thereby removing one of the key differences between them. When the proposed disbursement quota rules were first announced in the 2004 Federal budget,⁴ the Charity and Not-For-Profit Law Section of the Canadian Bar Association “question[ed] the purpose of the distinction between charitable organizations and public foundations” and whether the “two concepts” should be merged into one.⁵ Further proposed sweeping changes to the Act affecting charities were released by the Department of Finance on July 18, 2005.⁶ In light of these new changes to the Act, it brings into question the justification for maintaining the current categorization of charitable organizations and public foundations.

This paper traces the tax policy that led to the current tripartite categorization of charities under the Act, and reviews whether the tripartite categorization of charities should be maintained or should be revised by combining charitable organizations and public foundations into one category in order to provide a simpler and more efficient regime for the regulation of charities.

In recent years, the regulation of charities under the Act has been under much review. For example, Professor A. Abigail Payne recently examined the differences between public and private foundations and proposed that greater transparency and public disclosure would put the public and private foundations on level ground and therefore would not be necessary to treat these foundations differently under the Act.⁷ Some disagreed with Payne’s view and supported keeping the current legislation;⁸ others supported relaxing regulations over private foundations.⁹ Other proposals include completely revamping the current regulatory system and replacing the term “charity” with the term “public benefit organization,”¹⁰ and establishing an independent

³ S.C. 2005, c. 19 (hereinafter referred to as “Bill C-33”).

⁴ Canada, Department of Finance, *Budget* (Ottawa: March 23, 2004) see Notice of Ways and Means Motion Resolution 25 and Annex 9.

⁵ Canadian Bar Association, Submission by the Charity and Not-For-Profit Law Section (April 2004).

⁶ Canada, Department of Finance, *Legislative Proposals Relating to Income Tax* (Ottawa: July 18, 2005). The July 2005 proposal is a package of changes that consolidates and further amends previously proposed amendments introduced by the Department on December 20, 2002, December 5, 2003, and February 27, 2004.

⁷ A. Abigail Payne, *Firm Foundations: Putting Private and Public Foundations on Level Ground*, C.D. Howe Institute Backgrounder no. 88 (Toronto: C.D. Howe Institute, February 2005) (online http://www.cdhowe.org/pdf/backgrounder_88.pdf). See also A. Abigail Payne, “Response” (2005) 53(3) Canadian Tax Journal 751.

⁸ William I. Innes and Patrick J. Boyle, “Shaky Foundations? A Defence of Special Rules for Private Foundations” (2005) 53(3) Canadian Tax Journal 739.

⁹ Wolfe D. Goodman, “Reflections on Tax-Assisted Giving in Canada.” (2005) 53(3) Canadian Tax Journal 747.

¹⁰ Arthur B.C. Drache with F.K. Boyle, *Charities, Public Benefits and the Canadian Income Tax System: A Proposal for Reform* (Toronto: Kahanoff Foundation Non-Profit Sector Research Initiative, 1998).

agency to oversee charities.¹¹ Issues involving these proposals or involving private foundations¹² will not be discussed in this paper, except where it is necessary as part of the discussion that relates to the categorization of charitable organizations and public foundations under the Act. Furthermore, it is also outside the scope of this paper to review what the meaning of “charity”, “charitable activity” or “charitable purpose” means.¹³

B. Overview of the current tripartite division of charities under the Act

A “registered charity” is defined in the Act to mean a “charitable organization, private foundation or public foundation ... that is resident in Canada and was either created or established in Canada” (or a “branch, section, parish, congregation or other division of an organization or foundation” of any of these that is resident in Canada, was either created or established in Canada and that receives donations on its own behalf) and is registered with the Minister of National Revenue.¹⁴

Charitable organizations, public foundations and private foundations are separately defined and regulated under the Act.¹⁵ These entities differ in a number of respects, including organizational form, relationship between directors/trustees and their control by major donors, disbursement quota obligations, business activities, granting activities, borrowing activities, and control of other corporations. Each of these areas will be reviewed in this paper in detail after

¹¹ See, for example, Ontario Law Reform Commission, *Report of the Law of Charities* (Toronto: Ontario Law Reform Commission, 1996); Patrick Monahan and Elie S. Roth, *Federal Regulation of Charities: A Critical Assessment of Recent Proposals for Legislative and Regulatory Reform* (Toronto: Kahanoff Foundation Non-Profit Sector Research Initiative, 2000); Ronald D. Hirshhorn and David Stevens, “Organizational and Supervisory Law in the Nonprofit Section”, CPRN Working Paper No. CPRN 01 (Canadian Policy Research Networks Inc. 1997); Lorne Sossin, “Regulating Virtue: A Purposive Approach to the Administration of Charities” in Phillips et. al. (eds.) *Between State and Market: Essays on Charities Law and Policy in Canada* (Montreal: McGill-Queen’s University Press, 2001); and Arthur B.C. Drache with W. Laird Hunter, “A Canadian Charity Tribunal: A Proposal for Implementation” (Toronto: Kahanoff Foundation Non-Profit Sector Research Initiative, 2000).

¹² For details regarding the regulation of private foundations under the Act, see M. Elena Hoffstein and Robin P. Roddey, “Private Foundations and Community Foundations” (2001) 49(5) *Canadian Tax Journal* 1258; and Wolfe Goodman and Howard Carr, updated by Peter Broder, with assistance from David Stevens, *Establishing a Private Foundation* (Toronto: Canadian Centre for Philanthropy, 1987, updated 2002).

¹³ See, for example, David P. Stevens, “Update on Charity Taxation” in Report of Proceedings of Fifty-Third Tax Conference, 2001 (Toronto: Canadian Tax Foundation, 2002), 28:1-41.

¹⁴ Subsection 248(1) of the Act.

¹⁵ See their definitions in subsection 149.1(1) of the Act.

first reviewing the historical development of the tripartite division of charities. Set out below is a brief summary of these differences to provide a background prior to the said historical review.¹⁶

In summary, a charitable organization must devote all of its resources to charitable activities carried on by the organization itself, and no part of its income may be payable to, or is otherwise available for, the personal benefit of any of its “proprietor, member, shareholder, trustee or settlor.”¹⁷ A charitable organization may grant up to 50% of its income annually to other qualified donees¹⁸ (and up to 100% of its income to associated charities¹⁹), may carry on related businesses²⁰ (which include unrelated businesses substantially run by volunteers²¹), and may be constituted as a corporation, a trust or an incorporated association.²²

A “charitable foundation” may be organized as a corporation or a trust (but not as an unincorporated association), constituted exclusively for charitable purposes, and is not a charitable organization. No part of its income may be payable to, or is otherwise available for, the personal benefit of any of its “proprietor, member, shareholder, trustee or settlor.”²³ A charitable foundation may be either a public foundation or a private foundation.²⁴

Public foundations may carry on related business activities,²⁵ while private foundations cannot.²⁶ Foundations are prohibited from incurring debts other than debts for current operating

¹⁶ See also Theresa L.M. Man and Terrance S. Carter, “A Comparison of the Three Categories of Registered Charities” *Charity Law Bulletin* No. 73 (21 July 2005) (online: www.charitylaw.ca); Theresa L.M. Man and Terrance S. Carter, “How do charitable organizations and foundations differ under income tax?” *The Lawyers Weekly* Vol 25, No. 16 (2 September 2005).

¹⁷ See paragraphs (a) and (b) in the definition for “charitable organization” in subsection 149.1(1) of the Act.

¹⁸ Paragraph 149.1(6)(b) of the Act. 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. Registered national arts service organizations are deemed to be registered charities under subsection 149.1(6.4) of the Act. 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. This proposed amendment is brought forth and is now included in the proposed amendments released by the Department of Finance on 18 July 2005.

¹⁹ Paragraph 149.1(6)(c) of the Act.

²⁰ Paragraphs 149.1(6)(a) and 149.1(2)(a) of the Act.

²¹ See definition for “related business” in subsection 149.1(1) of the Act.

²² See definition for “charitable organization” in subsection 149.1(1) of the Act. See also, Canada Revenue Agency, Guide T4063, *Registering a Charity for Income Tax Purposes* (Ottawa: August 2002).

²³ See definition for “charitable foundation” in subsection 149.1(1) of the Act.

²⁴ See definition for “public foundation” and “private foundation” in subsection 149.1(1) of the Act.

²⁵ Paragraph 149.1(3)(a) of the Act.

expenses, the purchase and sale of investments, or the administration of the charitable activities.²⁷ Foundations are also prohibited from acquiring control of any corporation.²⁸ Public foundations must give more than 50% of their income annually to other qualified donees, but this requirement does not apply to private foundations.

Prior to Bill C-33, the disbursement quota rules²⁹ for charitable organizations and public foundations were significantly different. New disbursement quota rules were enacted by Bill C-33 so that the same disbursement quota rules now apply to charitable organizations and public foundations. The disbursement quota rules for private foundations are almost the same as those that apply to charitable organizations and public foundations. To summarize, the new rules require all charitable organizations and public foundations to generally disburse 80% of gifts received in the immediately preceding year and enduring property expended in the year, as well as 100% of enduring property transferred to qualified donees in the year and gifts received from other charities in the immediately preceding year. In addition, all charities are also required to expend at least 3.5% of their assets not used directly in their charitable activities or administration, if the value of their assets is more than \$25,000. The new rules also permit encroachment on realized capital gains of enduring property to satisfy the 3.5% disbursement quota are also enacted.³⁰

The Act currently provides that (1) 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, and (2) 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.³¹ This is usually referred to as the "contribution" test. On July 18, 2005, the Department of Finance released legislative proposals³² to amend the definitions of both charitable organizations and public foundations to ensure that in certain circumstances large donations are not prohibited by

²⁶ Paragraph 149.1(4)(a) of the Act.

²⁷ Paragraph 149.1(3)(d) and 149.1(4)(d) of the Act.

²⁸ Paragraphs 149.1(3)(c) and 149.1(4)(c) of the Act.

²⁹ See definition for "disbursement quota" in subsection 149.1(1) of the Act.

³⁰ See *infra*, page 19 for details.

³¹ However, funds received from the federal government, provincial governments, municipalities, other registered charities that are not private foundations, as well as non-profit organizations are exempted. For charitable foundations that were registered before 15 February 1984, the capital contribution rate was 75%. See also the definition for "charitable organization" and "public foundation" in subsection 149.1(1) of the Act.

³² See *supra* note 6 and *infra* page 20.

replacing the “contribution test” with a “control test,” which permits a donor(s) to contribute more than 50% of the charity’s capital as long as the donor(s) does not control the charity in any way or represent more than 50% of the directors, trustees, officers or similar officials of the charity. These amendments have not been introduced in Parliament for enactment. However, once enacted, these amendments will become generally retroactive to January 1, 2000.

Set out below is a comparison chart setting out the main differences between the three categories of registered charities.³³

Table 1: Differences between charitable organizations, public foundations and private foundations

Characteristics	Types of Registered Charities		
	Charitable Organizations	Public Foundations	Private Foundations
(1) Relationship between directors/trustees and control by donors	The Act currently requires that (1) 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, and (2) 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 (except funds received from the federal government, a provincial government, a municipality, other registered charities that are not private foundations, and non-profit organizations). This is usually referred to as the “contribution” test. But the Act has been proposed to be amended to replace the “contribution test” with a “control test” in subsection 149.1(1) of the Act, whereby it would 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 or similar officials of the charity. In general, this new definition is retroactively applicable to January 1, 2000.		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.
(2) Disbursement quota rules	Prior to Bill C-33, the disbursement quota rules for charitable organizations and public foundations were different. However, the Act is now amended by Bill C-33, 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: <ul style="list-style-type: none"> • The disbursement formula is $A + A.1 + B + B.1$ • 80% disbursement quota • 3.5% disbursement quota • possible encroachment on capital gains pool of enduring property to satisfy the 3.5% disbursement quota 		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% (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) Business activities	Charitable organizations can carry on related businesses (which include unrelated businesses substantially run by volunteers)		Private foundations cannot carry on any business

³³ Based on the table in *Charity Law Bulletin* No. 73 by Man and Carter, *supra* note 16 at 8.

Characteristics	Types of Registered Charities		
	Charitable Organizations	Public Foundations	Private Foundations
(4) Granting activities	Charitable organizations primarily carry on their own charitable activities, may give funds to other qualified donees, may not disburse more than 50% of their income annually to qualified donees, unless they are associated charities.	Public foundations must give more than 50% of their income annually to other qualified donees.	Private foundations may carry on their own charitable activities, and Canada Revenue Agency takes the position that there is no requirement on private foundations to give more than 50% of their income annually to other qualified donees.
(5) Organizational form	Charitable organizations must be organized as corporations, unincorporated associations or charitable trusts.	Public and private foundations must be organized as either corporations or trusts.	
(6) Borrowing activities	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 their 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.	

C. Historical development of the tripartite division of charities

Before reviewing whether the current tripartite categorization of charities should be maintained or be re-categorized, it is important to first review the history of the various amendments to the Act in order to understand the tax policy that these provisions are intended to achieve. Only those legislative changes that affect or are relevant to the categorization of registered charities are reviewed in this paper, other changes, for example, the deductibility or tax treatment of charitable donations,³⁴ are not.

1. Pre-1967

The current categorization of registered charities was first introduced in 1967. The OLRC Report indicated that the registration of charities prior to 1967 were unsophisticated.³⁵ The *Income War Tax Act*,³⁶ enacted in 1917, provided that the income of “religious, charitable,

³⁴ For example, see David G. Duff, “Tax Treatment of Charitable Contributions in Canada: Theory, Practice, and Reform” (2004) 42 Osgoode Hall L.J. 47.

³⁵ The OLRC Report, *supra* note 2 at 261.

³⁶ *Income War Tax Act*, 1917, 7-8 Geo 5, c. 28 (Can.), subsection 5(d).

agricultural and education institutions” were exempt. In 1917, there was no requirement for these entities to register.³⁷

In 1948, in order to ensure that “all organizations that were charitable according to the common-law definition be eligible for the exemption,”³⁸ the applicable section of the legislation was amended to refer to these institutions as “charitable organizations” when the *Income War Tax Act* was replaced by the *Income Tax Act*.³⁹ In the same year, the Minister of National Revenue acknowledged there was no master list of all charities, since each income tax district kept their own list. As a result, all charities wanting to issue charitable receipts were required to complete a prescribed form for recognition as charitable organizations.⁴⁰

In 1950, for the first time, charities were divided into charitable organizations, charitable trusts, and charitable corporations.⁴¹ One of the amendments to the Act in 1950 was to explicitly exempt “foundations” as granting institutions in order to “ensure that it was clear that charitable trusts as well as charitable corporations were included” in the exemption provision.⁴² A 90% disbursement requirement and a prohibition on carrying on business activities for “foundations” were adopted to curtail abuses by foundations.⁴³

³⁷ In 1917, only war charities defined under the *War Charities Act, 1917*, 7-8 Geo. 5, c. 38 (Can.), were required to register in order to “control fraudulent ‘war-charity’ appeals and to encourage the efficient operation of legitimate war charities.” The *War Charities Act, 1917*, was repealed in 1927 (by *An Act to repeal the War Charities Act, 1917*, S.C. 1926-27, c.39) but was again enacted between 1939 and 1946 to raise funds for the Second World War (*An Act to amend the Income War Tax Act*, S.C. 1939 (2d Sess.), c. 6, s. 1, enacting s. 5(1)(n) of the 1927 *Income War Tax Act*, S.C. 1940-41, c. 18, s. 7, re-enacting s.5(1)(j) of the *Income War Tax Act*, R.S.C. 1927, c. 97.) See also R. Watson, “Charity and the Canadian Income Tax: An Erratic History” (1985), 5(1) *Philanthropist* 3 at 5; and Can. H. of C. Deb., 1 February 1917, at 377-78. Subsection 2(b) of the *War Charities Act, 1917* defined war charities to be “any fund, institution or association, other than a church or the Salvation Army ... having for its object ... the relief of suffering or distress, or the supplying of needs or comforts to sufferers from the war, or to soldiers, returned soldiers or their families or dependents, or any charitable purposes connected with the present European war.”

³⁸ *Supra* note 35 at 257.

³⁹ *Income Tax Act*, S.C. 1947-48, c. 52 (Can.).

⁴⁰ Canada, Department of National Revenue, Form T.511, “Application for Recognition as a Charitable Organization”, as per Directive No. 141 (22 January 1948). See *supra* note 35 at 259, and Watson, *supra* note 37 at 9.

⁴¹ *An Act to Amend the Income Tax Act*, S.C. 1950, c. 40.

⁴² *Supra* note 35 at 257 and 261. The OLRC Report also observed at 257 that several cases held that exempt “institutions” did not include “trusts.” For example *Minister of National Revenue c. Trust & Guarantee Co.*, [1940] A.C. 138, [1939] 4 D.L.R. 417 (P.C.), and *Burns Executors c. Minister of National Revenue*, [1950] A.C. 213, [1950] 2 D.L.R. 529 (P.C.).

⁴³ *Supra* note 35 at 261. See also Can. H. of C. Deb., 18 May 1950, at 2617-21, whereby the Hon. Douglas Charles Abbott. M.P. indicated that the purpose of the amendment was to permit foundations “to set up businesses and claim immunity from taxing statutes, and simply to accumulate funds or accumulate control of corporations or businesses.” It was recognized that “there [had] been an opportunity for abuse in the case of these charitable foundations; that is to say, moneys could be accumulated in them and not actually paid over to charities” by accumulating gifts, investment and business income, winding up the foundations and distributing the accumulated funds to their “proprietors.”

Some of the rules that applied to these three types of charities became the predecessor of some of the current requirements under the Act that apply to registered charities, including the organizational form, “prohibitions against carrying on a business and against financing programs with debts” and “a rudimentary disbursement regime.”⁴⁴

In general, charitable organizations may be incorporated or unincorporated, devote all of their resources to charitable activities carried on by them, and no income may personally benefit any member thereof.⁴⁵ They were not expressly prohibited from carrying on business activities, as in the case for charitable corporations and trusts. However, there was an implied prohibition against doing so because, otherwise, they would not be devoting all their resources to charitable activities.⁴⁶

Charitable corporations could not carry on any business, could not incur any debts since June 1, 1950 (other than obligations for salaries, rents and other current operating expenses), must disburse 90% of their income on their charitable activities or by making gifts to other charitable organizations or charitable foundations (i.e. cannot disburse more than 10% of its income on their own activities), could not acquire control of other corporations after June 1, 1950, and could not allow any income to personally benefit any member thereof.⁴⁷

Charitable trusts were the same as charitable corporations, except they must disburse 90% of their income by making gifts to other charitable organizations or charitable foundations, and must be constituted as trusts with all property held in trust exclusively for charitable purposes.⁴⁸ “Charitable activities” and “charitable purposes” were not defined in the *Income Tax Act* and therefore relied on the common law for guidance.

2. 1967 tax reform and the Carter Commission

In the 1960s, a problem matching charitable deductions claimed by taxpayers and the amount of donations received by charities came to the attention of the government. By 1967, the

⁴⁴ *Supra* note 35 at 261. See also R. Appleby, “The Taxation of Charitable Institutions” (1973), 1(2) *Philanthropist* 17; J.G. Smith, “Taxation of Charitable Organizations Under the Income Tax Act” in Report of the Proceedings of the Twenty-fifth Tax Conference, 1973 (Toronto: Canadian Tax Foundation, 1973) 160, and E.A. Chater, “Administrative Aspects of the Taxation of Charitable Organizations Under the Income Tax Act” in Report of the Proceedings of the Twenty-fifth Tax Conference, 1973 (Toronto: Canadian Tax Foundation, 1973) 176 for detailed analysis of these changes. Chater was the Director of Registration Division of the Department of National Revenue. See also Drache and Boyle, *supra* note 10, regarding the legislation adopted in 1950 and amendments in 1951.

⁴⁵ Paragraph 57(1)(ea) of the 1947-48 *Income Tax Act*, *supra* note 39.

⁴⁶ 1975 Green Paper, *infra* note 56 at 8 and 1976 Budget Paper, *infra* note 57 at 4.

⁴⁷ Paragraph 57(1)(eb) of the 1947-48 *Income Tax Act*, *supra* note 39.

⁴⁸ Paragraph 57(1)(ec) of the 1947-48 *Income Tax Act*, *supra* note 39.

Minister of National Revenue admitted his department “had no idea how many charitable organizations, local as well as national, there were in Canada claiming the section 62(1)(e) tax exemption” under the 1952 *Income Tax Act*.⁴⁹ As a result, amendments were enacted, effective January 1, 1967, to require all charities to register and file annual information returns if they received donations and wished to have its receipts qualify for income tax deductions. Therefore, if a charity had no desire to issue such receipts, there was no need for them to register, because their tax-free status flowed from the nature of their operation as a charity at common law.⁵⁰ Other changes regarding donation receipts and the establishment of a new “Charitable and Non-Profit Organization Section” in the department to oversee charities were also enacted.⁵¹ The OLRC Report noted that the 1967 tax reform “marked a watershed in the legal regulation of charitable organizations.”⁵² It further observed that “[i]t represented the first time that a realistic effort was made to regulate the sector in a systematic and comprehensive way.”⁵³

At the same time, the Royal Commission on Taxation (the “Carter Commission”) completed its report.⁵⁴ The Carter Commission’s recommendations relating to charities included, among others, taxing business income earned by charities at the corporate rate, and establishing an inter-departmental supervisory body to assess the eligibility of organizations for the tax-exemption status.⁵⁵

3. The 1976-77 tax reform

In 1975, the Department of Finance released a discussion paper, *The Tax Treatment of Charities* (the “1975 Green Paper”).⁵⁶ After reviewing more than 200 briefs and 30 oral

⁴⁹ See the OLRC Report, *supra* note 35 at 262 and 263 and Watson, *supra* note 37 at 10-11.

⁵⁰ Arthur B.C. Drache and Robert Hayhoe, *Canadian Taxation of Charities and Donations* (Toronto: Thomson Canada Limited, 2005, 1994) at 1-30.

⁵¹ Can. H. of C. Deb., 7 June 1966, at 6114ff (Mr. Benson) and *An Act to amend the Income Tax Act*, S.C. 1966-67, c. 47, ss. 3 and 15, amending *Income Tax Act*, R.S.C. 1952, c. 148, ss. 27 – 125 respectively. See also S.A. Martin, *Financing Humanistic Service* (Toronto: McClelland & Stewart, 1975) at 42-43, 203-205 and 208-216 for a helpful summary of the changes.

⁵² *Supra* note 35 at 250.

⁵³ *Ibid.*

⁵⁴ Canada, *Report of the Royal Commission on Taxation* (Ottawa: Queen’s Printer, 1966) (Commissioner: K. Le M. Carter), vols. 3, 4 (hereinafter referred to as the “Carter Commission”).

⁵⁵ See F.L. Woodman, “The Tax Treatment of Charities and Charitable Donations Since the Carter Commission: Tax Reform and Present Problems” (1988) 26 Osgoode Hall L.J. 537 at 539-544 for a helpful summary of the relevant recommendations made by the Carter Commission.

⁵⁶ Canada, Department of Finance, *The Tax Treatment of Charities* (Discussion Paper) (Ottawa: 23 June 1975) (hereinafter referred to as the “1975 Green Paper”).

representations in response to the 1975 Green Paper,⁵⁷ new changes to the Act were enacted in 1976, effective January 1, 1977.⁵⁸ The 1976 Budget Paper released by the Department of Finance indicated that the purposes of the proposed changes were to ensure that “tax-exempt monies flowing to charities are used as intended – as efficiently as possible, and for strictly charitable purposes, not private gain,” because “revenue forgone as a result of deductions or exemptions ... impose an equivalent extra tax burden on all other taxpayers.”⁵⁹ Similarly, the 1975 Green Paper indicated that “[e]very dollar of tax relief represents a cost to the Canadian taxpayer,” and the “government therefore believes that it is appropriate that the rules of taxation ensure that the people of Canada obtain maximum benefit from the charities.”⁶⁰ Some observed that the approach taken in the 1975 Green Paper was “both simple and reasonably effective,”⁶¹ and that the proposed tax changes were “a major tax reform within an area which was well thought out, well handled and well received.”⁶² However, others were “skeptical of its motives, critical of its design, and very quick and acute in their reactions against the proposals.”⁶³

a) New categorization of charities

The 1976 Budget Paper indicated that there were two kinds of charities in Canada, namely “active charities which provide[d] services and carr[ied] out charitable activities; and foundations which distribute[d] funds to be employed by others for charitable purposes,” and that “[f]oundations tend[ed] in turn to be of two types – those which [were] broadly representative, with donations received from the public at large; and those which [were] founded and controlled by one person or one family.”⁶⁴ Others have observed that the 1950 categorization of charities was “incoherent” and “made little sense” because “charitable organizations were identified by virtue of their active capacity, regardless of their legal form, whereas charitable trusts were

⁵⁷ Canada, Department of Finance, *Budget Paper D: Charities under the Income Tax Act* (Ottawa: 25 May 1976) at 2 (hereinafter referred to as the “1976 Budget Paper”). See also Arthur B.C. Drache, Viewpoint “The 1981 Budget: Failure of Process?”, [1982] *Philanthropist* (Summer) 43.

⁵⁸ S.C. 1976-77, c. 4.

⁵⁹ *Supra* note 57 at 3.

⁶⁰ *Supra* note 56 at 5. The OLRC Report, *supra* note 35 at 272, commented that this was the first time “federal tax policy was explicitly formulated in the rhetoric of the tax expenditure theorists: the government’s ultimate objective was to deploy the tax subsidy to the maximum benefit of Canadians,” and therefore, “in the logic of this view, . . . charitable dollars were considered government dollars.”

⁶¹ *Supra* note 55 at 549.

⁶² Drache, *supra* note 57 at 44.

⁶³ OLRC Report, *supra* note 35 at 273 and D. S. Rickerd, “The Charitable Organization’s Viewpoint” in Report of Proceedings of the Twenty-Seventy Tax Conference, 1975 (Toronto: Canadian Tax Foundation, 1975) 381 at 382.

⁶⁴ *Supra* note 57 at 4.

defined by virtue of both their legal form and their passive or grant-making functions, and charitable corporations, paradoxically, were defined solely in their legal form.”⁶⁵

Therefore, in 1977, charities were re-categorized according to their functions, i.e. active charities (i.e. charitable organizations) and passive charities (i.e. charitable foundations). Charitable foundations were further divided into “public foundations” (by combining the previous categories of charitable corporations and charitable trusts) and “private foundations,” which was a new category introduced in 1977 to address concerns of abuses involving family foundations of their tax-exempt status.⁶⁶ Therefore, by segregating “private foundations” as a separate category, it became possible to subject them to more stringent regulatory requirements. The general term “registered charities” replaced the former term “registered Canadian charitable organizations.”

Under the new categorization, a public foundation was required to meet two testes: its controlling directors or trustees were required to deal with each other at arm’s length and less than 75% of its capital was required to have been contributed by one person or by a group of related persons. A private foundation was defined to be a foundation that was not a public foundation. Charitable organizations, however, were required to have more than 50% of their directors, trustees, officers or officials deal with each other at arm’s length. The contribution test did not apply to charitable organizations.⁶⁷

⁶⁵ *Supra* note 35 at 274. Woodman, *supra* note 55 at 547 indicated that in 1976, over 90% of the charities were classified as charitable organizations, and that since charitable organizations were not permitted to transfer funds to other charities, some charitable organizations had problems complying with the rules under the Act.

⁶⁶ The 1975 Green Paper, *supra* note 56 at 9, indicated that these changes were intended to address abuses by family foundations by “arranging investments and expenses to ensure that the charity has little income and pays out a relatively small sum annually in comparison to its capital,” possibly by “having the charity invest in low-yield debts or equity of the donor’s business, by renting premises from the donor at high rent, by paying family members high salaries for relative little work or by lending money to family members at low rates of interest. For a more detailed explanation of these abuses, see Donovan W.M. Waters, *Waters’ Law of Trusts in Canada*, 3rd ed. (Toronto: Thomson Canada Limited, 2005) at 666. For example, by transferring shares of a family or associated persons’ business to a foundation, growth of the business (and later capital gains) became the property of the charity, the charity played the part of a voting trust and the family members or associates became directors or trustees of the charity, minority shares had a lower value, take-over bids and proxy fights were discouraged, the pressure to declare dividend was reduced (because the charity was exempt from tax), deletion of the business assets through estate tax on the death of the family member or associate was eliminated, no-interest or low-interest loans were made to the business company, and the charity borrowed money in order to extend its portfolio of investments. Another potential abuse involved the charity renting premises from the donor at a high figure, and employed executives at high salaries and benefits. The OLRC Report, *supra* note 35 at 273 and 274, observed that these concerns of the Department of Finance set out in the 1975 Green Paper were similar to the abuses experienced in the United States at the time.

⁶⁷ See definition for “charitable organization” and “public foundation” in subsection 149.1(1) of the Act. See also Drache and Hayhoe, *supra* note 50 at 2-15, 2-16 and 3-13.

b) Disbursement quota

Private foundations were required to disburse the greater of 5% of the fair market value of their non-arm's length investments (i.e. non-qualified investments) and 90% of the actual income therefrom. This "disbursement quota" applied with a one-year lag time to allow directors to determine the amount required to be disbursed in the following year. The purpose of the amendment was to ensure private foundations earned enough from their non-arm's length investments to meet the 5% disbursement quota requirement and that "charitable activities received some reasonable level of benefit from foundations enjoying tax advantages."⁶⁸ This rule did not apply to arm's length investments in the open market (i.e. qualified investments, such as publicly traded securities), capital property used directly in the foundation's own activities or amounts being accumulated for specific projects approved by the Minister of National Revenue. Private foundations were required to disburse at least 90% of income generated from other sources, e.g. from donations and qualified investments (but not include capital gains from investments). The 5% rule was phased in over three years between 1977 and 1979.

Both charitable organizations and public foundations were required to disburse at least 80% of its previous year's received donations, but, in the case of public foundations, ten-year gifts⁶⁹ were not included. The 80% rule was phased in over four years between 1977 and 1980. The purpose of the 80% rule was to address the issue of increasing fundraising costs in order to ensure that most of the funds received by charities were used in charitable activities.⁷⁰

c) Distribution of income

Prior to 1977, charitable organizations were prohibited from distributing funds to other charities because "it would distract from their role in carrying on direct charitable activities."⁷¹ The Act was amended to permit charitable organizations to distribute up to 50% of its annual income to other registered charities, and up to 100% to other registered charities that were

⁶⁸ OLRC Report, *supra* note 35 at 276 and D. Macdonald, Budget Speech, Can. H. of C. Deb., 25 May 1976, at 13831-32.

⁶⁹ Ten-year gifts are gifts directed by the donor to be held by the charity for at least 10 years.

⁷⁰ The 1975 Green Paper, *supra* note 56 at 11, indicated that high fundraising costs were problematic because (1) it might be used as a "technique to siphon off substantial funds to the organizers of a charity, with a very small benefit accruing to its real purpose"; and (2) it might discourage the public from donating funds to charities "for fear that the money [would] not be employed toward the stated objectives." The 1975 Green Paper originally proposed to amend the Act by deregistering charities if their fundraising costs exceeded 50% of the funds donated in that year. This proposal was not adopted, but the 80% disbursement rule was adopted instead.

⁷¹ 1975 Green Paper, *supra* note 56 at 7.

designated as “associated” with the transferor charities. The 1975 Green Paper clarified that the purpose of this amendment was as follows:

The 50 per cent limit on distribution is designed to maintain a distinction between registered charities which essentially carry on their activities directly (charitable organizations) and those which are essentially distributors of funds (charitable foundations). The distinction continues to be necessary because charitable organizations are subject to significantly less control under the new proposals than charitable foundations. This preferential treatment can be accorded because the very nature of direct charitable activity precludes many of the abuses of most concern to the government. If charitable organizations could distribute all their income annually, most foundations would endeavor to be classified as charitable organizations in order to qualify under the less stringent rules which apply to charitable organizations.⁷²

The Act was also amended to provide that a transfer of funds which was established as “capital” of a transferor charity would be treated as capital of the transferee charity, so that the transferee charity would not need to include the transfer in its 90% disbursement rule or the rule requiring all resources be used for charitable purposes. The Act was also amended to exclude ten-year gifts (rather than gifts to be held in perpetuity) from “capital” of foundations.

d) Carrying on business

The Department of Finance recognized there were good reasons for charities to carry on businesses, such as a gift store in an art gallery and a cafeteria in a hospital. The law had been administered to permit charitable organizations to operate businesses if they were directly related to their charitable activities.⁷³ The Act was therefore amended to expressly permit charitable organizations and public foundations to carry on business activities that were related to their charitable activities. The 1975 Green Paper clarified that the mere holding of equity in a corporation would not be treated as carrying on business.⁷⁴ In addition, it was permissible to carry on unrelated businesses provided they were operated substantially by volunteers. The establishment of criteria for a related business was left for Canada Revenue Agency (then known as Revenue Canada).⁷⁵

⁷² The 1975 Green Paper, *supra* note 56 at 7 and 8.

⁷³ There was an express prohibition in the case of public foundations and an implied prohibition in the case of charitable organizations.

⁷⁴ The 1975 Green Paper, *supra* note 56 at 11.

⁷⁵ *Supra* note 57 at 5.

e) Accumulation of income

Due to the requirement on charitable organizations to disburse all of its resources on charitable activities and 90% in the case of foundations, it was difficult for them to accumulate funds for major projects. The Act was amended to legitimize the then administration to permit charities to accumulate funds for major projects, subject to prior approval from the Minister of National Revenue.⁷⁶

f) Other changes

Other changes were also implemented in 1977, including increased disclosure requirements on charities in their annual information return, including income, donations received, gifts made, costs of fundraising, overhead expense, salaries to senior employees, etc. The information would become a public document. The Act also required charities to register with Canada Revenue Agency⁷⁷ whether or not they wished to issue receipts, in order to obtain tax-free status. This status would be lost upon de-registration at the discretion of the Minister of National Revenue.⁷⁸ Lastly, when the 1977 changes were enacted, the charitable status of all charities was “grandfathered.”⁷⁹

4. The 1984 tax reform

Changes to the *Income Tax Act* were proposed in the MacEachen’s Budget of November 1981⁸⁰ in order to prevent charities from circumventing the disbursement rules, increasing the 5% disbursement rule for private foundations to 10% and including capital gains in income of foundations.⁸¹

As a result of the opposition from the sector to the proposals in the 1981 Budget,⁸² the government made new proposals in a Press Release in April 1982.⁸³ The 1982 Press Release proposed to replace the 90% income disbursement rule that applied to foundations with a 4.5% disbursement requirement on the fair market value of their assets not used in their charitable

⁷⁶ *Supra* note 56 at 9 and *supra* note 57 at 8.

⁷⁷ Then known as Revenue Canada.

⁷⁸ The 1975 Green Paper, *supra* note 56 at 11 and 12, and the 1976 Budget Paper, *supra* note 57 at 6-8.

⁷⁹ Drache and Hayhoe, *supra* note 50 at 1-31.

⁸⁰ Canada, Department of Finance, *Budget* (Ottawa: November 1981), see Resolutions 138 and 139.

⁸¹ See resolutions 138 and 139 of the MacEachen’s Budget. See OLRC Report, *supra* note 35 at 277 to 279 and Woodman, *supra* note 55 at 551-555 for a summary of these proposals.

⁸² See for example, Drache, *supra* note 55 and “Submission of the Associating of Canadian Foundations to the Minister of Finance on the Budget Proposals of November 12, 1981” (1982) *Philanthropist* (Summer) 25.

⁸³ Canada, Department of Finance, *Press Release* (Ottawa: 21 April 1982).

activities or administration, irrespective of the form of investments. This new rule would relieve the need of foundations to calculate their income, something that was difficult to calculate, and would not require capital gains to be disbursed. The 1982 Press Release also proposed to apply the 4.5% disbursement rule to non-qualified investments and loans to related persons would be required to earn interest larger than a prescribed rate of return. In October 1982, the new Minister of Finance announced a delay in implementing the proposals.

In May 1983, the Department of Finance proposed new changes by releasing a discussion paper, *Charities and the Canadian Tax System* (the “1983 Discussion Paper”).⁸⁴ It contained six proposals, including (1) eliminating the legislative distinction between the categories of charities to allow “charities the flexibility to change their methods of operation to suit changing circumstances without being confined by the existing concepts of foundations and organizations” and, in that regard, the same disbursement rules would apply to all charities; (2) charities would be “related” if they had one major donor in common or if one charity was the major donor of the other; (3) all charities would be required to disburse 80% of their income (with certain exceptions) and 4.5% of their investments; (4) charities that fail to meet their disbursement obligations would be subject to a tax on the shortfall; (5) the concept of non-qualified investments would apply to all charities; and (6) persons who benefited from non-qualifying investments that yield less than a prescribed rate of return would be required to include twice the amount of the benefit in their income subject to tax. The resulting draft legislation was more complex than the then current regime. The proposed changes were strenuously opposed by the charitable sector.⁸⁵ Further details and ramifications of these proposed changes are discussed below in this paper.

Legislation was enacted in 1984⁸⁶ to implement changes originally proposed in the 1982 Press Release as well as other changes. The effect of the 1984 changes basically established the current regime. Both public and private foundations were subject to a 4.5% disbursement requirement on their investments. The 90% income disbursement rule was eliminated. Problems

⁸⁴ Canada, Department of Finance, *Charities and the Canadian Tax System A Discussion Paper* (Ottawa: May 1983) (hereinafter referred to as the “1983 Discussion Paper”).

⁸⁵ See C.A. Bond, “Implications for Charitable Foundations” in Report of Proceedings of the Thirty-fifth Tax Conference, 1983 (Toronto: Canadian Tax Foundation, 1983).

⁸⁶ *An Act to amend the Income Tax Act and related statutes*, S.C. 1984, c. 45. See also M.L. Dickson and Laurence C. Murray, “Recent Tax Developments” (1984) 4(2) *Philanthropist* 51; and M.L. Dickson and Laurence C. Murray, “Recent Tax Developments” (1985) 5(1) *Philanthropist* 56.

with inter-charity transfers intended to be addressed by the 1981 Budget⁸⁷ were addressed by requiring public foundations to disburse 80% of the previous year's receipts from any registered charity, and 100% in the case of private foundations. Ten-year gifts and testamentary gifts were exempted from the disbursement requirements of charitable organizations. Charitable organizations and public foundations registered after February 15, 1984, were required to have more than 50% of their directors, trustees, officers or officials deal with each other at arm's length and not more than 50%⁸⁸ of the contributed capital could come from one person or group of people not dealing at arm's length.⁸⁹ Their disbursement requirement remained at 80%.⁹⁰

5. Other tax reforms in 1980s and 1990

In 1985, legislation was enacted to permit charities to engage in political activities under certain circumstances.⁹¹ In 1986, complicated rules regarding the calculation of the 4.5% disbursement quota were rewritten and made generally retroactive to 1983.⁹² Deductions for charitable donations were changed to tax credits in 1988.⁹³ In 1990, Canada Revenue Agency⁹⁴ released a Discussion Paper⁹⁵ on various administrative practices and making charities more accountable. In 1994, the disbursement quota rules were expressed in an algebraic formula while maintaining the same rules with no policy change.⁹⁶

6. 1996 Ontario Law Reform Commission

In 1989, the Ontario Attorney General asked the OLRC to study the law governing charities and to make recommendations respecting the laws to govern charities in modern

⁸⁷ The OLRC Report, *supra* note 35 at 278, indicated that “the fact that charitable organizations and public foundations were required to disburse only a percentage of receipted gifts; the fact that one charity could make a grant from its income to another charity in the form of an endowment (a “ten-year gift”), turning income in the hands of the first charity into non-disbursable capital in the hands of the second; and the fact that related charities with different year ends could make grants back and forth forever without ever having to expend a cent on charitable work.”

⁸⁸ Reduced from 75% for those public foundations registered on or before 15 February 1984.

⁸⁹ See definition for “charitable organization” and “public foundation” in subsection 149.1(1) of the Act. See also Drache and Hayhoe, *supra* note 50 at 2-15, 2-16 and 3-13.

⁹⁰ See OLRC Report, *supra* note 35 at 284, and Woodman, *supra* note 55 at 558-559.

⁹¹ *An Act to amend the Income Tax Act [and other legislation]*, S.C. 1986, c. 6, s. 85(2), enacting s. 149(6.1) and (6.3) of the 1952 *Income Tax Act*, R.S.C. 1952, c.148, applicable to 1985 and subsequent taxation years.

⁹² See Drache and Hayhoe, *supra* note 50 at 3-17 for a summary of these changes.

⁹³ S.C. 1988, c. 55, enacted following the 18 June 1987 White Paper on tax reform.

⁹⁴ *Supra* note 77.

⁹⁵ Revenue Canada, *A Better Tax Administration in Support of Charities* (Discussion Paper) (Ottawa: 1990). See also E.B. Bromley, “A Response to ‘A Better Tax Administration in Support of Charities’” (1991) 10(3) *Philanthropist* 3.

⁹⁶ See Drache and Hayhoe, *supra* note 50 at 3-20 to 3-22 for a summary.

times.⁹⁷ The OLRC prepared its report in 1996. Among the recommendations, the OLRC recommended the following:

(7) The Income Tax Act should not attempt to define “charity.” It should continue to use the basic classifications “public” and “private” “foundations” and “charitable organizations.” It should require every charity over a certain size to be organized as a trust or a corporation.

...

(14) The Act should not attempt to regulate the borrowing activities of charities, except where the borrowing is so imprudent that it jeopardizes the existence of the charity.

(15) The rules in the Act governing the permissible granting activities of charities are unnecessarily complex. There should also be an obligation on granting charities to require their recipients to account for the expenditure of grants received.

(18) The revenue base for the disbursement quota should be the same for all charities, but the percentage amounts required to be spent should be lower for charitable organizations than for foundations. The disbursement quota should be simplified and used only to require charities to do charity.⁹⁸

Reference will be made to these recommendations later in this paper.

7. Other reports between 1998 to 2003

After the OLRC Report, there were a number of reports and proposals prepared by the charitable sector in relation to the regulation of charities in Canada.⁹⁹ In 1998, Arthur Drache prepared a working paper,¹⁰⁰ recommending significant changes, including a proposal for a new term “public benefit organization” to replace the term “charity” under the *Income Tax Act*. This paper was relied on extensively by the subsequent report of the Voluntary Sector Roundtable (“VSR”), chaired by Ed Broadbent, *Building on Strength: Improving Governance and Accountability in Canada’s Voluntary Sector*, in February 1999 (the “Broadbent Report”)¹⁰¹ on how to promote accountability and governance in the voluntary sector. After the release of the Broadbent Report, voluntary sector members and federal officials met in three “Joint Tables” to make recommendations in relation to improving the regulation, administration and accountability of charities and other non-profit organizations, and to examine federal funding support. On

⁹⁷ OLRC Report, *supra* note 35 at 1.

⁹⁸ Recommendation #26 in OLRC Report, *supra* note 35 at 630-632.

⁹⁹ See Monahan and Roth, *supra* note 11, for a summary of these reforms up to 2000.

¹⁰⁰ Drache and Boyle, *supra* note 10.

¹⁰¹ Panel on Accountability and Governance in the Voluntary Sector, *Building on Strength: Improving Governance and Accountability in Canada’s Voluntary Sector* (Ottawa: The Panel, February 1999) (hereinafter referred to as the “Broadbent Report”).

August 28, 1999, the Joint Tables released their joint report, *Working Together, A Government of Canada/Voluntary Sector Joint Initiative*,¹⁰² which delineated three areas requiring strategic investment and attention: (1) improving the relationship between the government and the sector; (2) enhancing the capacity of the sector to serve Canadians; and (3) improving the legislative and regulatory environment in which the sector operates. It is for the third area that the Joint Regulatory Table was formed in November 2000 and released their report in March 2003, entitled *Strengthening Canada's Charitable Sector: Regulatory Reform* (the "JRT Report").¹⁰³ A number of recommendations contained in the JRT Report include improving the transparency of the regulator's framework and the appeals system, as well as implementing intermediate sanctions.¹⁰⁴

8. Bill C-33 enacted on May 13, 2005

In addition to implementing some of the recommendations by the JRT Report, the Federal Budget announced on March 23, 2004¹⁰⁵ also implemented sweeping changes to the disbursement quota rules that apply to charities. The changes were introduced as Bill C-33 enacted on May 13, 2005.¹⁰⁶

The new disbursement quota rules are very complicated and led to a lot of negative feedback from the charitable sector. Prior to the enactment of Bill C-33, the disbursement quota rules for charitable organizations and public foundations were significantly different. However, the new disbursement rules for charitable organizations and public foundations are now the same, subject to some transitional provisions.

The following is a brief summary of these new rules. The 4.5% disbursement quota was reduced to a more manageable rate of 3.5% for taxation years beginning after March 22, 2004, in order to provide relief to the charitable sector, since charities have found it difficult to meet the 4.5% disbursement quota when interest rates are low without expending a portion of the capital

¹⁰² Federal/Voluntary Sector Joint Tables, *Working Together, A Government of Canada/Voluntary Sector Joint Initiative* (28 August 1999).

¹⁰³ Joint Regulatory Table, *Strengthening Canada's Charitable Sector: Regulatory Reform* (March 2003) (hereinafter referred to as the "JRT Report").

¹⁰⁴ See also Arthur B.C. Drache, "Regulatory Table Report Now Available" (June 2003) 11(6) Canadian Not-For-Profit News 42.

¹⁰⁵ *Supra* note 4.

¹⁰⁶ *Supra* note 3.

of the bequest or ten-year gifts.¹⁰⁷ The 3.5% disbursement quota, previously applicable to public and private foundations, is now also applied to charitable organizations. However, the 3.5% disbursement quota does not apply to charities whose investment assets are less than \$25,000.

A new concept of “enduring property”¹⁰⁸ was introduced, which includes (1) gifts received by way of a bequest or inheritance (including gifts of life insurance proceeds, registered retirement income funds and registered retirement savings plans as a result of direct beneficiary designation); (2) gifts received by a charitable organization from another registered charity to be expended in the next 5 years or less in its charitable activities; (3) ten-year gifts; and (4) gifts received by the charity as a transferee of (1) and (3) above. In general, a charity will be permitted to encroach on the capital gains of enduring property up to a maximum of the lesser of 3.5% of the charity’s investment assets and its “capital gains pool,”¹⁰⁹ which is a notional account of the realized capital gain from the disposition of enduring property declared by the charity on its T3010 Registered Charity Information Return. Finally, transfers from registered charities to charitable organizations, previously exempt from the 80% disbursement quota, are now subject to the 80% disbursement requirement, except those involving specified gifts and enduring property.

The effect and ramification of the new disbursement quota rules are discussed in greater detail below in this paper.

9. July 18, 2005 proposals

On July 18, 2005, the Department of Finance released legislative proposals (the “July 2005 Amendments”)¹¹⁰ to amend the Act. The July 2005 proposal is a package of changes that

¹⁰⁷ See Stevens, *supra* note 13 at 28:39-40 and James W. Kraft, “Alternatives to the Disbursement Quota of Charities”, Discussion Paper (Canadian Association of Gift Planners, 2002) for a summary of the problems faced by charities in meeting the 4.5% disbursement quota.

¹⁰⁸ See definition for “enduring property” in subsection 149.1(1) of the Act.

¹⁰⁹ See definition for “capital gains pool” in subsection 149.1(1) of the Act.

¹¹⁰ See Theresa L.M. Man, “July 18, 2005 Draft Amendments To The Income Tax Act Affecting Charities: Part I – Definition of Gift & Split-Receipting” *Charity Law Bulletin* No. 76 (8 September 2005); and “July 18, 2005 Draft Amendments To The Income Tax Act Affecting Charities: Part II – Other Changes” *Charity Law Bulletin* No. 77 (8 September 2005) (online: www.charitylaw.ca).

consolidates and further amends previously proposed amendments introduced by the Department of Finance on December 20, 2002, December 5, 2003, and February 27, 2004.¹¹¹

For charitable organizations and public foundations, the Act currently provides that more than 50% of directors or trustees must deal with each other at arm's length, and not more than 50% 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% of the charity's capital as long as the donor does not control the charity or represent more than 50% of the directors or trustees of the charity. These amendments, which were first proposed on December 20, 2002, and revised on February 27, 2004, and again on July 18, 2005, once enacted, will become generally retroactive to January 1, 2000. The definition of private foundations remains unchanged.

D. Differences between three types of registered charities under the Act – an analysis

The current tripartite categorization of charities under the Act was first implemented in 1977. The tax policy for such a categorization, as explained in the 1976 Budget Paper, was the recognition that there are two kinds of charities in Canada, namely “active charities which provide services and carry out charitable activities; and foundations which distribute funds to be employed by others for charitable purposes,” and that “[f]oundations tend in turn to be of two types – those which are broadly representative, with donations received from the public at large; and those which are founded and controlled by one person or one family.”¹¹²

Premised upon this tax policy, charitable organizations, public foundations and private foundations are defined and regulated differently in the Act, and they differ in a number of respects, including organizational form, relationship between directors/trustees, control by major donors, disbursement quota obligations, business activities, granting activities, borrowing activities, and control of other corporations. Each of these aspects is reviewed in this paper.

¹¹¹ See Theresa L.M, Man and Terrance S. Carter, “Commentary on Draft Technical Amendments to the Income Tax Act Released on December 20, 2002 that Affect Charities” *Charity Law Bulletin* No. 21 (30 April 2003); Theresa L.M, Man and Terrance S. Carter, “December 5, 2003 Income Tax Act Amendments Affecting Charities” *Charity Law Bulletin* No. 38 (19 February 2004); and Theresa L.M, Man and Terrance S. Carter, “February 27, 2004 Revised Draft Amendments to the Income Tax Act Affecting Charities” *Charity Law Bulletin* No. 40 (29 March 2004) (online: www.charitylaw.ca).

¹¹² *Supra* note 57 at 4.

Where applicable, the regulatory regime in the United Kingdom and/or the United States would be referred to as well.

1. Organizational form

The definition for “charitable organization” indicates that it is an organization that may either be incorporated or unincorporated.¹¹³ As such, charitable organizations can be organized either as corporations, unincorporated associations established by constitution, or charitable trusts.¹¹⁴ The definition for “charitable foundation,”¹¹⁵ however, indicates that public and private foundations must either be corporations or trusts. Therefore, the only difference in the organizational form between charitable organizations and public foundations is that public foundations are not permitted to be organized as unincorporated associations, but it is possible to do so for charitable organizations.

As explained above on page 7, income of “religious, charitable, agricultural and education institutions” was first exempt from tax in 1917 under the *Income War Tax Act*.¹¹⁶ These entities were referred to as “charitable organizations” in 1948 under the *Income Tax Act*, in order to ensure that “all organizations that were charitable according to the common-law definition be eligible for the exemption.”¹¹⁷ Charitable organizations maintained their tax-exempt status after the 1950 tax reform when two additional categories of charities, namely, charitable corporations and charitable trusts, were recognized under the *Income Tax Act* in order to explicitly exempt “foundations” and ensure that charitable trusts as well as charitable corporations were also exempt from tax.¹¹⁸ These two categories of charities were combined in 1977 and became “public foundations” in 1977.¹¹⁹ Neither the 1975 Green Paper nor the 1976 Budget paper discussed the tax policy behind the three categories of charities.

The OLRC Report recommended in 1996 that the Act “should require every charity over a certain size to be organized as a trust or a corporation.”¹²⁰ In making this recommendation, the OLRC commended as follows:

¹¹³ See the definition for “charitable organization” in subsection 149.1(1) of the Act.

¹¹⁴ *Supra* note 22.

¹¹⁵ See the definition for “charitable foundation” in subsection 149.1(1) of the Act.

¹¹⁶ *Supra* note 36.

¹¹⁷ *Supra* note 39.

¹¹⁸ *Supra* note 42..

¹¹⁹ See page 11 above.

¹²⁰ The OLRC Report recommendation #26(7), *supra* note 2 at 630.

We do not think the current regime is wise to require that foundations be organized on a more formal basis, as trusts or corporations, and not as unincorporated associations. *The justification for this, in the Commission's view, is that these entities generally are larger and therefore require a more stable and detailed organic law. Given that the justification is based on size, some thought should be given at the federal level to requiring organizations structured as unincorporated associations to reorganize as corporations or as trusts, once they reached a certain size. The chief value of the unincorporated association form of organization is its flexibility and ease of entry. It thus facilitates the spontaneity for which the sector is so highly valued. Once an unincorporated association has reached a certain size and has existed for a certain time, however, concern for the adequacy of its basic law should outweigh the need for flexibility and ease of entry.* We make no suggestion as to the appropriate size; obviously any test will be somewhat arbitrary. We suggest only that the test should include an element going to absolute size (in revenue or assets) and an element going to durability or staying power. *We suspect that in many instances, entities registered as unincorporated associations would discover that, in fact, they are, in whole or in part, charitable trusts.*¹²¹ [emphasis added]

Since charitable organizations have the ability to operate as unincorporated associations, there does not appear to be any rationale prohibiting foundations to operate as unincorporated associations.

First, there is no reason why public foundations could not be organized as unincorporated associations. An unincorporated association is not a separate legal entity and has no legal status apart from its members. It does not create a “legal person” but does create a legal relationship among the members. An unincorporated association is “essentially, an agreement among a number of persons which articulates their common purpose, establishes an organization to achieve that common purpose and sets out how that organization is to be operated to achieve that purpose” and the “relationship among the persons is contractual in nature.”¹²² Although an unincorporated association is unable to hold property in its own name, it is possible to hold property in the name of individuals as trustees for the members of the unincorporated association. It is unable to sue, be sued, or enter into contracts. The members of the unincorporated association would have to be individually named as defendants in a lawsuit against an

¹²¹ The OLRC Report, *supra* note 2 at 338.

¹²² Donald J. Bourgeois, *The Law of Charitable and Not-for-Profit Organizations*, 3rd ed. (Toronto: Butterworths, 2002) at 40.

unincorporated association, and an unincorporated association exposes its members, in addition to its directors, to personal liability.¹²³

In fact, in the United Kingdom, a charity may be organized as unincorporated associations, corporations or trusts.¹²⁴ The same applies in the United States.¹²⁵

Second, I agree with the comment made by the OLRC Report that “entities registered as unincorporated associations would discover that, in fact, they are, in whole or in part, charitable trusts.” All charities are established to further general charitable purposes that are recognized at common law and are described in the constating documents of the charities.¹²⁶ The *Restatement of Trusts* of the American Law Institute¹²⁷ defines a charitable purpose trust as follows:

A charitable purpose trust is a fiduciary relationship with respect to property arising as a result of a manifestation of an intention to create it, and subjecting the person by whom the property is held to equitable duties to deal with the property for a charitable purpose.

The OLRC Report summarizes the basic nature of a charitable purpose trust as follows:

. . . [A] promise or undertaking made by the initial trustee, followed by undertakings of his or her successor trustees, to apply a certain locus of wealth, sometimes in perpetuity, to a particular purpose. So analyzed, it is more akin to an oath or a vow, albeit legally enforceable, than to a bilateral contract. It is this feature that gives it its special and problematic juridical character.¹²⁸

When unrestricted gifts are made by donors to a charitable organization for the general charitable purposes of the charity that are set out in its constating documents, those gifts are held beneficially by the charitable corporation to further its general charitable purposes. This principle

¹²³ See Chapter 16 of the OLRC Report, *supra* note 2 at 507, for a summary of the law in relation to unincorporated associations.

¹²⁴ Peter Luxton, *The Law of Charities* (Oxford: Oxford University Press, 2001) at 255. See also United Kingdom, Charities Commission, *Registering as a Charity* (London: Charities Commission, 2004).

¹²⁵ Bruce R. Hopkins, *The Law of Tax-Exempt Organizations* (8th ed.) (New Jersey: John Wiley & Sons, Inc.) at 63-64, 961-962.

¹²⁶ At common law, there are four recognized heads of charitable purposes, namely the relief of poverty, the advancement of education, the advancement of religion, and other purposes beneficial to the community. A “charitable purpose” is generally used in the context of a charitable purpose trust but has application to other legal forms of charities as well.

¹²⁷ American Law Institute, *Restatement of Trusts* (Washington D.C.: 1959) at para. 348.

¹²⁸ The OLRC Report, *supra* note 2 at 395.

has been confirmed by the Ontario Court of Appeal in the *Christian Brothers* case.¹²⁹ Donors may make a gift to a charity to be held by the charity “in trust” for a specific charitable purpose that falls within the parameters of the general charitable purposes of that charity. The trust that is created by such a gift is called a “special purpose charitable trust” (“SPCT”). The charity is, in effect, managing a separate specific charitable purpose trust within the parameters of its own general charitable purpose, i.e. a charity within a charity. A SPCT is often also referred to as a “donor restricted trust fund,” a “charitable trust property,” a “special purpose fund,” an “endowment fund,” or a “restricted fund.” There is a long line of case law that recognizes the existence of SPCT as being distinct from the general charitable purpose of the charity that administers the SPCT.¹³⁰ The trustees of a SPCT can be an unincorporated association or a corporation at civil law. A SPCT is created when the donor expresses an intention that the property being given to the charity is to be held for a specific charitable purpose rather than for the general charitable purposes of the charity. Where the intention is clear, an express SPCT is created. However, where there is no express document creating the trust or where the donor’s intention is not clearly expressed when the gift is made to the charity, but may be discovered from evidence surrounding the circumstances when the gift was made, an implied SPCT may be created.¹³¹

Therefore, I would agree with the recommendations of the OLRC Report in that charitable organizations and public organizations be permitted to be organized as unincorporated associations, corporations or trusts provided that they are under a certain size, and require unincorporated associations to reorganize as corporations or as trusts once they are over a certain size. In determining guidelines on the appropriate size, factors such as value of assets or revenue, value of liability, value of real property owned, etc. could be taken into consideration.

¹²⁹ *Christian Brothers of Ireland in Canada (Re)* (1998), 37 O.R. (3d) 367, 21 E.T.R. (2d) 117 (Gen. Div.), rev’d (2000), 47 O.R. (3d) 674 (C.A.); *Christian Brothers of Ireland in Canada (Re)*, (2000), 47 O.R. (3d) 674 (C.A.), rev’g (1998), 37 O.R. (3d) 367, application for leave to appeal to the Supreme Court of Canada dismissed, 16 November 2000; *Rowland v. Vancouver College Ltd.* (2000), 78 B.C.L.R. (3d) 87, 34 E.T.R. (2d) 60 (S.C.), aff’d (2001), 94 B.C.L.R. (3d) 249 (C.A.); *Rowland v. Vancouver College Ltd.* (2001), 94 B.C.L.R. (3d) 249 (C.A.), aff’g 78 B.C.L.R. (3d) 87 (S.C.), application for leave to appeal to the Supreme Court of Canada dismissed, 23 May 2002.

¹³⁰ For example, the *Christian Brothers* series of cases, *supra* note 129; *Ukrainian Youth Association of Canada v. Executors of the Estate of Michael Galandiuk and the Public Guardian and Trustee* (17 September, 2001) (Ont. C.J.) [unreported].

¹³¹ Terrance S. Carter, “Donor-Restricted Charitable Gifts: A Practical Overview Revisited II” (2003) 18(1) *Philanthropist* 5, and (2003) 18(2) *Philanthropist* 121.

2. Relationship between directors/trustees and control by major donors

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, except funds received from the federal government, provincial governments, municipalities, other registered charities that are not private foundations, as well as non-profit organizations. This is usually referred to as the "contribution" test. For charitable foundations that were registered before February 15, 1984, the capital contribution rate was 75%.¹³²

The 50% arm's length test was implemented for charitable organizations and public foundations in 1977. For public foundations, there was an additional 75% contribution test. In 1984, the 75% contribution test was reduced to 50% and was made applicable to both charitable organizations and public foundations.

As a result of inquiries from the public, on July 18, 2005, the Department of Finance proposed to amend the definitions of both charitable organizations and public foundations in order to ensure that in certain circumstances large donations are not prohibited by replacing the "contribution test" with a "control test."¹³³ The proposed rules would permit a donor to contribute more than 50% of the charity's capital as long as such a donor does not control the charity in any way or represent more than 50% of the directors, trustees, officers and similar officials of the charity. Funds received from the federal government, provincial governments, municipalities, other registered charities that are not private foundations, as well as non-profit

¹³² See also the definition for "charitable organization" and "public foundation" in subsection 149.1(1) of the Act. See also Drache and Hayhoe, *supra* note 50 at 2-15, 2-16 and 3-13.

¹³³ *Supra* note 6. The July 2005 proposal is a package of changes that consolidates and further amends previously proposed amendments introduced by the Department on 20 December 2002, 5 December 2003 and 27 February 2004. These amendments have not been introduced in Parliament for enactment. However, once enacted, these amendments will become generally retroactive to 1 January 2000.

organizations are not subject to the “control test.”¹³⁴ There is no change to the current definition for private foundations, i.e. neither the requirement that 50% of the directors/trustees/officers of a private foundation must be at arm’s length, nor the requirement that not more than 50% of the funds received comes from one donor or donors who are at arm’s length apply to private foundations.

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. In addition, 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.¹³⁵ In addition, the proposed control test also appears to be vague and problematic. For example, it appears to apply to a donor who has made contributions at two points in time. It is unclear whether the wording would imply that a donor who has made a one time donation that is greater than 50% of the charity’s capital (without having made a prior contribution) is permissible, or that a donor may be able to avoid the application of this paragraph by making a small donation between the two large contributions contemplated in the definition.¹³⁶

The application of the control test and the contribution test are the same for both charitable organizations and public foundations. In order to reflect the “public” nature of these charities, it is reasonable to require that the directors and trustees of these two categories of charities be required to be at arm’s length and not be controlled by a donor. However, the application of the proposed tests should be clarified in the draft legislation.

¹³⁴ 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 will be required to apply within 90 days of when the July 2005 proposals 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.

¹³⁵ For example, would a foundation board of “legal strangers” who are employees or board members of a business corporation that created the foundation be a public or private foundation? See Drache and Hayhoe, *supra* note 50 at 1-10.2 and Canadian Bar Association, Submission by the Charity and Not-for-Profit Law Section to the Standing Committee on Finance on its Pre-Budget Consultations (13 September 2005).

¹³⁶ Submission by the Canadian Bar Association, *supra* note 135.

3. Disbursement quota obligations

The disbursement quota is a prescribed amount that registered charities must disburse each year in order to maintain their charitable registration. The purpose of the disbursement quota is “to ensure that most of a charity’s funds are used to further its charitable purposes and activities; to discourage charities from accumulating excessive funds; and to keep other expenses at a reasonable level.”¹³⁷

a) Historical development

By way of background, in 1950, for the first time, a 90% disbursement requirement was imposed on charitable corporations and charitable trusts to curtail abusive situations involving foundations accumulating funds in the foundations and distributing the accumulated funds to their “proprietors” without disbursing them on charitable programs.¹³⁸

In 1977, private foundations were required to disburse the greater of 5% of the fair market value of their non-arm’s length investments (i.e. non-qualified investments) and 90% of the actual income therefrom. The 5% rule did not apply to public foundations or charitable organizations. Both charitable organizations and public foundations were subject to a new 80% disbursement quota requirement, which applied to their previous year’s receipted donations, but, in the case of public foundations, it would not include ten-year gifts (i.e. gifts directed by the donor to be held by the charity for at least 10 years). The purpose of the 80% rule was to address the issue of increasing fundraising costs in order to ensure that most of the funds received by charities are used in charitable activities.¹³⁹

In 1984, public and private foundations were subject to a 4.5% disbursement requirement on their investments. The 90% income disbursement rule was eliminated. In addition, public foundations were required to disburse 80% of the previous year’s receipts from any registered charity in order to prevent related charities with different year ends making grants back and forth forever without ever having to expend funds on charitable work.¹⁴⁰

¹³⁷ See Canada Revenue Agency, Information Circular RC 4108, *Registered Charities and the Income Tax Act* (Ottawa: updated 7 May 2002).

¹³⁸ *Supra* note 43.

¹³⁹ *Supra* note 70.

¹⁴⁰ *Supra* note 87.

b) Disbursement quota rules immediately prior to Bill C-33

Immediately prior to the enactment of Bill C-33, the disbursement quota rules for charitable organizations and public foundations were significantly different. These rules have been criticized for not being equitable or efficient.¹⁴¹

Although both charitable organizations and public foundations were required to expend 80% of the previous year's received donations on their charitable programs or on gifts to qualified donees,¹⁴² only charitable foundations (but not charitable organizations) were also required to disburse 4.5% of their assets not used directly in their charitable activities or administration. This was one of the key differences between charitable organizations and foundations. The value of the assets was based on the average value of the registered charities' assets not used directly in charitable activities or administration in the 24 months immediately preceding the taxation year.¹⁴³ It was expected that the foundation would be "earning a real rate of return on its investments close to or a bit more than 4.5 percent, and thus the disbursement quota is calculated so that there is little opportunity for capital growth due to investment earnings over the long term."¹⁴⁴ Charitable organizations, however, were not required to comply with this 4.5% disbursement quota.

Another key difference between charitable organizations and public foundations was that funds received by public foundations from other charities (except where the gifts were received as "specified gifts") were included in the disbursement quota calculation of public foundations, while funds received by charitable organizations from other charities were not included in their disbursement quota calculation.

c) New disbursement quota rules enacted by Bill C-33

With the enactment of Bill C-33 on May 13, 2005, all differences in the disbursement requirements between charitable organizations and public foundations were removed so that the same disbursement quota rules now apply to charitable organizations and public foundations,

¹⁴¹ Kraft, *supra* note 107 at 5-7.

¹⁴² Receipts by charities not subject to the 80% disbursement quota include (1) gifts to all charities from donors who did not require donation receipts; (2) receipts by charitable organizations from other charities (this exception did not apply to charitable foundations); (3) 10 year gifts; and (4) other revenue receipts, e.g. income from investment, related businesses, fundraising.

¹⁴³ *Income Tax Regulations* 3700 to 3702 provide a detailed mechanism to calculate the "prescribed amount" for purposes of calculating "D."

¹⁴⁴ Stevens, *supra* note 13 at 28:38.

subject to some transitional provisions.¹⁴⁵ To summarize, the new rules now require both charitable organizations and public organizations to disburse at least, generally, (1) 80% of gifts received in the immediately preceding year; (2) 80% of enduring property expended in the year and 100% of enduring property transferred to qualified donees, less the optional reduction by the amount of realized capital gains on enduring property; and (3) 100% of gifts received from other charities in the immediately preceding year. In addition, both charitable organizations and public organizations are also required to expend at least 3.5% of their assets not used directly in their charitable activities or administration, if the value of their assets is more than \$25,000. New rules regarding the encroachment on capital gains pool of enduring property to satisfy the 3.5% disbursement quota have also been enacted. These new rules apply to registered charities effective retroactively as of March 23, 2004, except that the 3.5% disbursement quota will not apply to charitable organizations registered before March 23, 2004 until their taxation years that begin after 2008.

d) Ramifications of the new disbursement quota rules

Prior to the enactment of Bill C-33, the disbursement quota rules for charitable organizations were much simpler and more lenient than those that applied to public foundations. With the enactment of Bill C-33, the disbursement quota rules for both charitable organizations and public foundations are now the same by (1) requiring charitable organizations to be subject to the 3.5% disbursement quota; and (2) including funds received by charitable organizations from other registered charity in their disbursement quota calculation.

The Department of Finance explained in the 2004 Federal budget that the reason for extending the reduced 3.5% disbursement quota to charitable organization was because nowadays both public foundations and charitable organizations may hold capital endowments from which investment income is generated, while historically, only foundations were the primary beneficiaries of endowments. The Department of Finance, therefore, decided that all registered charities should be subject to the same disbursement quota.

Two alternative observations may be drawn from this rationale of the Department of Finance.

¹⁴⁵ *Supra* page 5. See M. Elena Hoffstein and Theresa L.M. Man, “New Disbursement Quota Rules under Bill C-33” (Paper presented to the Canadian Bar Association/Ontario Bar Association 3rd National Symposium on Charity Law, 6 May 2005) for details (online: www.charitylaw.ca).

i) Operating agencies vs. funding agencies

The 4.5% disbursement quota was previously imposed on public foundations premised on the assumption that foundations are funding agencies and charitable organizations are operating agencies.¹⁴⁶ If this tax policy assumption continues to be valid, then it would not be reasonable to apply the same disbursement quota requirements on charitable organizations and public foundations.

In relation to the new requirement that funds received by charitable organizations from other charities be included in the disbursement quota calculation for charitable organizations, the 2004 Federal budget did not provide any explanation for the proposed change. It only pointed out the fact that both charitable organizations and foundations may receive funds transferred from other charities and those received by charitable organizations were not included in their disbursement quota. There is nothing in the Act to prevent charitable organizations from building up endowment funds. In fact, prior to Bill C-33, all funds received by charitable organizations from other charities were exempt from disbursement requirements. The purpose of this exception was to “permit charitable organizations to build up capital endowments with gifts intended for that purpose.”¹⁴⁷

Furthermore, the disbursement quota calculation for public foundations was considerably more complex than that for charitable organizations. The OLRC Reported indicated that the purpose of the more complex requirement was “to ensure that money donated by the public [was] actually employed, within a short space of time, in charitable work” and “to control against the undue accumulation of wealth by charitable entities.”¹⁴⁸ Therefore, imposing more lenient disbursement requirements on charitable organizations and more stringent ones on public foundations was consistent with the tax policy that charitable organizations are operating agencies and foundations are funding agencies.

Although Bill C-33 attempts to provide relief to small charities by providing a *de minimis* threshold to exempt all charities owning less than \$25,000 in investment assets from compliance with the 3.5% disbursement calculation, the threshold is thought by many to be too low and does

¹⁴⁶ The 1976 Budget Paper, *supra* note 64 indicated that there are two kinds of charities in Canada, namely “active charities which provide services and carry out charitable activities; and foundations which distribute funds to be employed by others for charitable purposes.”

¹⁴⁷ *Supra* note 2 at 305. See also Stevens, *supra* note 13 at 28:37.

¹⁴⁸ *Supra* note 2 at 306.

not provide much relief at all. For example, when the Department of Finance proposed to apply the same disbursement quota rules to all charities in 1983, it was proposed that charities with investment assets less than \$250,000 and did not give more than 25% of their charitable outlays to other charities would be exempt from the 4.5% disbursement quota.¹⁴⁹ The \$250,000 threshold proposed in 1983 was ten times the current \$25,000 threshold.

Therefore, in order to be consistent with the tax policy, a more appropriate alternative would be to revise the disbursement quota rules so that they would be simpler and easier to administer.¹⁵⁰ Detailed analysis of a possible alternative disbursement quota is outside the scope of this paper.

ii) A new tax policy premise?

Alternatively, given the fact that Bill C-33 was enacted to apply the same disbursement rules to both charitable organizations and public foundations, it implies that the tax policy of treating foundations as funding agencies and charitable organizations as operating agencies is no longer a valid tax policy held by the Department of Finance in regulating charitable organizations and public foundations under the Act.

Historically, the Department of Finance proposed that the same disbursement quota (i.e. a 80% disbursement quota on all gifts received and 4.5% of the value investments) apply to all charities. The 1983 Discussion Paper¹⁵¹ indicated that the application of the 4.5% disbursement quota to all charities (including charitable organizations) would “provide a fairer disbursement requirement than the test related to income of foundations in that it would no longer vary depending on whether the return on investments is in the form of income or capital gains,” and “would make it easier for most foundations to protect the real value of their investments in an inflationary period.” The 1983 Discussion Paper indicated that the new uniform disbursement quota rules would avoid charities minimizing their disbursement requirements by changing their status.¹⁵² The OLRC Report indicated that this proposal “represented a major reversal in policy, given the statements in the 1975 Green Paper that ‘charities in Canada are essentially of two kinds[:] active charities which provide and carry out charitable activities; and foundations which

¹⁴⁹ 1983 Discussion Paper, *supra* note 84 at 10.

¹⁵⁰ See for example discussion paper by Kraft, *supra* note 107. See also OLRC, *supra* note 156.

¹⁵¹ *Supra* note 84.

¹⁵² *Supra* note 84 at 2.

distribute funds to be employed by others for charitable purposes.”¹⁵³ As a result, the proposal was strongly opposed by the charitable sector, especially charitable organizations, since “they were the major losers under these rules and they had had no warning in the years leading up to the discussion paper that the regime applicable to them would change in such a substantial way,” and the “outcry against the collapsing of the distinction between foundations and organizations was unanimous.”¹⁵⁴ As a result of the outcry, the 1983 proposes were withdrawn by the Department of Finance.

Prior to the enactment of Bill C-33, it was noted that the disbursement quota rules relating to foundations were already very complicated and “normally a foundation will have to use an accountant to determine what the requirements are.”¹⁵⁵ In 1996, the OLRC Report recommended that the “disbursement quota should be simplified and used only to require charities to do charity.”¹⁵⁶ Despite the request from the charitable sector to make the disbursement quota rules simpler, the new disbursement rules are now even more complicated than ever before (e.g. the tracking of the notional account of realized capital gain of enduring property in the capital gains pool).

4. Granting activities

Charitable organizations primarily carry on their own charitable activities. However, they may give funds to other qualified donees but may not disburse more than 50% of their income annually to qualified donees,¹⁵⁷ unless they are associated charities.¹⁵⁸ Since charitable organizations are required to devote their resources to charitable activities conducted by the organizations themselves, the transfer of up to 50% of the income of charitable organizations to qualified donees and up to 100% to associated charities are deemed to be expenditures by the charitable organization on its own charitable activities.¹⁵⁹ In addition, the transfer of capital to qualified donees by charitable organizations is also deemed to be a devotion of resources to their charitable activities.¹⁶⁰

¹⁵³ *Supra* note 2 at 281.

¹⁵⁴ *Supra* note 2 at 283.

¹⁵⁵ Drache and Hayhoe, *supra* note 50 at 3-19.

¹⁵⁶ Recommendation #26(18) in OLRC Report, *supra* note 35 at 632. In this regard, the OLRC Report, on pages 372-376, suggested a number of elements to be included in establishing a new disbursement quota formula.

¹⁵⁷ Paragraph 149.1(6)(b) of the Act.

¹⁵⁸ Paragraph 149.1(6)(c) of the Act.

¹⁵⁹ Paragraph 149.1(6)(b) and (c) of the Act.

¹⁶⁰ Subsection 149.1(10) of the Act.

Public foundations, however, must give more than 50% of their income annually to other qualified donees. However, this requirement is not explicitly set out in the Act. The Act provides that charitable organizations may not disburse more than 50% of their income annually to qualified donees.¹⁶¹ The definition for “charitable foundation” provides that a charitable foundation is “not a charitable organization.”¹⁶² As such, Canada Revenue Agency takes the 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, Canada Revenue Agency takes the 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. Canada Revenue Agency also takes the position that the definition for “private foundation,”¹⁶³ which indicates 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. In doing so, since charitable foundations are required to be “constituted and operated exclusively for charitable purpose,” “charitable purposes” is defined in the Act to “include the disbursement of funds to qualified donees.”¹⁶⁴

The OLRC Report noted that the rules regarding the granting activities are intended to achieve three objectives, namely (1) “to identify the major point of distinction between a foundation and a organization”; (2) “to permit legitimate reorganizations of charitable organizations and to permit coordination of activities among associated charitable organizations”; and (3) “in part, to inhibit the use of granting practices to circumvent the disbursement quota rules.”¹⁶⁵ The OLRC Report pointed out the weakness of each objective, and continued to indicate that the rules regarding the granting activities are “unnecessarily complicated” and should be simplified, by applying the same disbursement quota rules for charitable organizations and foundations.¹⁶⁶ It recommended that the “rules in the Act governing the permissible granting

¹⁶¹ Paragraph 149.1(6)(b) of the Act.

¹⁶² Subsection 149.1(1) of the Act.

¹⁶³ *Ibid.*

¹⁶⁴ See definition for “charitable foundation” and “charitable purposes” in subsection 149.1(1) of the Act.

¹⁶⁵ The OLRC Report, note 2 at 364.

¹⁶⁶ *Ibid.*

activities of charities are unnecessarily complex” and that “[t]here should also be an obligation on granting charities to require their recipients to account for the expenditure of grants received.”¹⁶⁷

The OLRC Report also pointed out that this regime is premised on the assumption that foundations are mainly funding agencies while charitable organizations are operating agencies.¹⁶⁸ However, as indicated above in the analysis of disbursement quota requirements, the assumption of foundations as funding agencies and charitable organizations as operating agencies is at odds with the application of the same disbursement quota rules to both charitable organizations and public foundations. If this tax policy reason is no longer of concern when enacting the new disbursement quota rules on charitable organizations and public foundations, this tax policy should also not be used as the basis for the rules respecting granting activities.

I therefore suggest that the restriction on granting activities of charitable organizations and public foundations be eliminated so that charities may determine what proportion of its income be used on its own charitable activities and in funding other qualified donees as their own circumstances may require.

5. Business activities

A charitable organization is considered to be devoting its resources to charitable activities it carries on. The Act considered that this requirement would be satisfied to the extent that it carries on a related business.¹⁶⁹ Therefore, charitable organizations are permitted to carry on “related businesses”, which is defined in the Act to include unrelated businesses run substantially by volunteers.¹⁷⁰ Canada Revenue Agency interprets this to require at least 90% of those engaged in the business activity are serving as unpaid volunteers.¹⁷¹ It is outside the scope of this paper to review what are considered at common law to be “related businesses.”¹⁷²

¹⁶⁷ Recommendation #26(15) in OLRC Report, *supra* note 35 at 631.

¹⁶⁸ The OLRC Report, *supra* note 2 at 303. See also Hirshhorn Stevens, *supra* note 11.

¹⁶⁹ Paragraph 149.1(6)(a) of the Act provides that a charitable organization is considered to be devoting its resources to charitable activities carried on by it to the extent that it carries on a related business.

¹⁷⁰ See definition for “related business” in subsection 149.1(1) of the Act.

¹⁷¹ See Canada Revenue Agency, Policy Statement CPS – 019, *What is a Related Business?* (Ottawa: 31 March 2003) at para. 18.

¹⁷² See Arthur B.C. Drache, “Related Business: What’s Okay and What’s Not”. (2004) 19(4) *Philanthropist* 273. See also *Alberta Institute on Mental Retardation v. the Queen* [1987] 2. C.T.C. 70, 87 D.T.C. 5306 and *Earth Fund v. The Queen* [2003] 2 C.T.C. 10 (F.C.A.). See also generally Raymond Dart, “Charities in Business, Business in Charities, Charities in Business – Mapping and Understanding the Complex Non-profit/Business Interface” (2004) 18(3) *Philanthropist* 181.

There is no express permission under the Act for public foundations to carry on business activities. However, the Act provides that the charitable status of public foundations may be revoked if they carry on a business activity that is not a related business.¹⁷³ Therefore, by implication, public foundations can also carry on related businesses. Private foundations, however, may not carry on any business activity, otherwise their charitable status may be revoked.¹⁷⁴

In 1950, when charitable corporations and charitable trusts were first recognized as charities under the Act, they were expressly prohibited from carrying on business activities but charitable organizations were not expressly prohibited from doing so. However, there was an implied prohibition against doing so because, otherwise, they would not comply with the requirement to devote all their resources to charitable activities.¹⁷⁵ Foundations were prohibited from carrying on business activities in order to prevent abuses involving foundations at the time.¹⁷⁶

In 1976, the government recognized that there were good reasons for charities to carry on businesses, such as a gift store in an art gallery and a cafeteria in a hospital. The law had been administered to permit charitable organizations to operate businesses.¹⁷⁷ The Act was therefore amended to expressly permit charitable organizations and public foundations to carry on charitable activities to carry on business activities that were related to their charitable activities. In addition, the carrying on unrelated businesses would be permitted provided they were operated substantially by volunteers. At the time, the government had reviewed the U.S. experience in taxing unrelated business income, and it was decided to be silent in the Canadian legislation in defining what “related business activity” means. Therefore, it was left for the Canada Revenue Agency to establish the criteria for what would constitute a related business.¹⁷⁸

The tax policy reasons in permitting these entities to continue engaging in related business activities continues to be valid today. The requirements under the Act in order to enable charitable organizations and public foundations to carry on business activities are the same. Further review in relation to the tax policy regarding the scope of business activities that should

¹⁷³ Paragraph 149.1(3)(a) of the Act.

¹⁷⁴ Paragraph 149.1(4)(a) of the Act.

¹⁷⁵ 1975 Green Paper, *supra* note 56 at 8 and 1976 Budget Paper, *supra* note 57 at 4.

¹⁷⁶ Can. H. of C. Deb., 18 May 1950, *supra* note 43.

¹⁷⁷ There was an express prohibition in the case of public foundations and an implied prohibition in the case of charitable organizations.

¹⁷⁸ *Supra* note 57 at 5.

be permitted to be carried on by charitable organizations and public foundations or the prohibition of private foundations from conducting business activities is outside the scope of this paper.

6. Control of other corporations

The Act does not contain any restriction to prohibit charitable organizations from controlling other corporations. As such, Canada Revenue Agency suggests 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.”¹⁷⁹ However, this option is not available to charities in Ontario as a result of the application of the *Charitable Gifts Act* (Ontario).¹⁸⁰

Since June 1, 1950, public and private foundations, however, are prohibited from acquiring control of any corporation.¹⁸¹ Failure to comply with this restriction may lead to the revocation of their charitable status. In this regard, control occurs when a foundation, or a foundation together with a person(s) who does not deal at arm’s length with the foundation, owns 50% or more of a corporation’s issued share capital, having full voting rights under all circumstances.¹⁸² This means that small (i.e. less than 50%) share holdings of a corporation are permitted. The Act also permits 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%.¹⁸³ Under such a situation, the foundation is deemed not to have acquired control of the corporation. This is because “acquire” does not include receiving by gift.¹⁸⁴

The OLRC Report commented that there is no reason to support such a prohibition:

Since very large corporations could thus be controlled by foundations, it is unclear what the restriction on the control of corporations is intended to accomplish. Moreover, there is nothing in the Act to prevent a charity from

¹⁷⁹ See *supra* note 171 at paragraphs 47 and 48.

¹⁸⁰ 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. But see Drache, *supra* note 172; Stevens, *supra* note 13 at 28:33-35.

¹⁸¹ Paragraphs 149.1(3)(c) and 149.1(4)(c) of the Act.

¹⁸² Paragraph 149.1(12)(a) of the Act.

¹⁸³ *Ibid.*

¹⁸⁴ Stevens, *supra* note 13 at 31 and see also Canada Revenue Agency, Document no. 9401445, 18 January 1994.

carrying on a business under a trust, and receiving business profits, tax free, as income distributed to it as a beneficiary. Thus, if the purpose of the restriction is to prevent foundations from owning a substantial stake in business enterprises and/or to preclude such businesses from escaping income taxes on their profits, as seems likely, it is seriously inadequate.¹⁸⁵

Although there may be valid policy reasons to prohibit private foundations from controlling businesses as pointed out above in relation to business activities of charities¹⁸⁶ to prevent controlling donors of private foundations from aggressive tax planning,¹⁸⁷ the comments by OLRC Report does apply in the case of public foundations because they are permitted to carry on related business activities like charitable organizations. Therefore, if charitable organizations are permitted to control other corporations, there does not appear to be any policy reasons to prohibit public foundations from doing so.

7. Borrowing activities

Since June 1, 1950, 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 the charitable activities, otherwise their charitable status would be revoked.¹⁸⁸ However, these restrictions that apply to public and private foundations do not apply to charitable organizations. Therefore, the ability of charitable organizations to raise funds by issuing charitable gift annuities does not apply to foundations, since an undertaking to make an annuity payment is a debt under the Act.¹⁸⁹

The purpose of the restrictions on foundations to incur debts is “to limit the permissible risks undertaken by foundations.”¹⁹⁰ The OLRC “[saw] no good reason ... for these restrictions”¹⁹¹ and therefore recommended that the “Act should not attempt to regulate the

¹⁸⁵ The OLRC Report, *supra* note 2 at

¹⁸⁶ *Supra* note 176.

¹⁸⁷ Innes and Boyle, *supra* note 8 at 743.

¹⁸⁸ Paragraph 149.1(3)(d) and 149.1(4)(d) of the Act.

¹⁸⁹ A charitable annuity is an arrangement under which a donor transfers capital to a charitable organization in exchange for immediate guaranteed payments for life at a specified rate depending on life expectancy or for a fixed term. See Canada Revenue Agency, Summary Policy CSP-A06, *Annuity – Planned Giving*, (Ottawa: 25 October 2002) and Canada Revenue Agency, Income Tax - Technical News No. 26 (Ottawa: 24 December 2002). IT-111R2 was archived on 14 July 2005.

¹⁹⁰ The OLRC Report, *supra* note 2 at 302; and Stevens, *supra* note 13 at 28:35.

¹⁹¹ The OLRC Report, *supra* note 2 at 364.

borrowing activities of charities, except where the borrowing is so imprudent that it jeopardizes the existence of the charity.”¹⁹²

The OLRC Report indicated that the only possible justification for the current restriction on borrowing activities of public foundations is that “they are an approximate or surrogate standard for some other policy concern.” One such concern is to ensure foundations “focus on charity and not allow themselves to be distracted by other goals.”¹⁹³ The OLRC Report continued to indicate this could be sufficiently addressed by requiring foundations to report on their borrowing activities annually in greater detail than what they are required to do so at this time. If charitable organizations are permitted to incur debts and would not be distracted from conducting charitable activities, there does not appear to be any policy reason to prohibit public foundations from doing so.

The other possible concern pointed out by the OLRC Report is that “charitable fiduciaries conduct the activities of the charity with the requisite level of care and competence, perhaps on the theory that the prohibited types of borrowing could never or rarely meet this standard.”¹⁹⁴ The OLRC Report did not agree there is sufficient tax policy reason to justify enforcement of this concern, “except in the case of investments, where the borrowing activity is imprudent to the point of being wasteful or ineffectual,” which could be addressed by imposing a restriction against all charities prohibiting such wasteful or ineffectual borrowing activity. In fact, if the concern that the prohibited types of borrowing could never or rarely meet the level of care and competence required of charitable fiduciaries, the same concern would also apply to charitable organizations, not just foundations.

In this regard, I agree with the recommendation of the OLRC in eliminating the stringent restrictions on public foundations in incurring debts. Instead, both charitable organizations and public foundations would be subject to a higher disclosure requirement and intermediate sanctions should be introduced to penalize charities that engage in imprudent borrowing activities.

¹⁹² Recommendation #26(18) in OLRC Report, *supra* note 35 at 632.

¹⁹³ The OLRC Report, *supra* note 2 at 364.

¹⁹⁴ *Ibid.*

E. Proposal for reform

As a result of the enactment of Bill C-33, one of the key differences between charitable organizations and public foundations has been removed by applying the same disbursement quota rules to them. Once this key difference is removed, the remaining differences between these two categories of charities are (1) prohibition on public foundations from being organized as unincorporated associations; (2) prohibition on public foundations from controlling other corporations; (3) severely restricting public foundations the ability to incur debts and obligations; and (4) requiring public foundations to give more than 50% of their income annually to other qualified donees (while charitable organizations are required to give less than 50% of their income annually to other qualified donees). These differences are premised on the flawed tax policy that public foundations are funding agencies while charitable organizations are operating agencies.

In contrast, in the United Kingdom, the registration of charities is not dependent on whether they are operating agencies or funding agencies.¹⁹⁵ In the United States, in general, charitable organizations are divided into two groups, public charities and private foundations, under section 501(c)(3) of the *Internal Revenue Code*.¹⁹⁶ All charitable organizations are deemed to be private foundations (which are subject to more stringent regulation) unless they qualify under section 509(a) of the *Internal Revenue Code*. In general, public charities have broad public support or actively function in a supporting relationship to such organizations.¹⁹⁷ Private foundations are charitable organizations that do not qualify as public charities. Generally, a private foundation is funded from one source, “its ongoing funding is usually in the form of investment income (rather than from a flow of investment income), and it makes grants for charitable purposes to other persons (rather than conducting its own programs).¹⁹⁸ Although private foundations in the United States are funding agencies, a public charity could either be a funding agency, an operating agency, or a combination of the two. In Canada, private foundations are similar to private foundations in the United States in this regard, in that they can carry on their charitable activities or fund other charities, without being subject to the arbitrary

¹⁹⁵ Luxton, *supra* note 124 at 22.

¹⁹⁶ 26 U.S.C.

¹⁹⁷ Hopkins, *supra* note 125 at 274. See also, United States of America, Internal Revenue Service, *Private Foundations* (Washington D.C.)

¹⁹⁸ Hopkins, *supra* note 125 at 274.

50% granting rule.¹⁹⁹ Therefore, there does not appear to be any basis to categorize registered charities in Canada in accordance to whether they function as funding agencies or operating agencies.

It is therefore proposed that the legislative differences between charitable organizations and public foundations be eliminated and these two categories of registered charities be combined into one category. In order to reflect the arm's length relationship of the directors and trustees of these charities and the lack of control of these charities by major donors (as opposed to the permissible non-arm's length relationship of the directors and trustees of private foundations and control by major donors), it is proposed that the new category be referred to as "public charities," by borrowing the terminology from the regulatory system in the United States. However, it is not proposed that other aspects of the regulatory system in the United States in regulating public charities and private foundations be adopted in Canada.

In adopting such a system, there would be two categories of registered charities, public charities and private foundations. Similar to the rationale behind the 1983 Discussion Paper, the consolidation of the two categories of charities into one would allow a significant simplification of the law and afford charities the flexibility to change their operations to adjust to changing circumstances in their charitable endeavors. A public charity would be able to determine whether it wishes to operate as a 100% operational agency, a 100% funding agency, or any combination of the two functions in any proportion, without being subject to any arbitrary restriction on its granting activities. Therefore, a public charity would be able to continue to take on the traditional functions for foundations if they so decide, including raising funds and building up endowments, holding assets of parallel operating charities for asset protection purposes (e.g. land holding foundations, intellectual property holding foundations, etc.), among other functions.

Private foundations will continue to comply with the rules that currently apply to them. Public charities, however, will continue to comply with the current rules that apply to charitable organizations and public foundations in relation to disbursement quota and the relationship between their directors, trustees, officers and officials. However, there will be following changes:

- a) Public charities would be permitted to be organized as unincorporated associations, corporations or trusts provided that they are under a certain size. Public charities that are organized as unincorporated associations would be required to reorganize as corporations or as trusts once they are over a certain size. In determining guidelines on the appropriate

¹⁹⁹ See *infra* page 33.

size as the reorganization threshold, factors such as value of assets or revenue, value of liability, value of real property owned, etc. could be taken into consideration.

- b) Public charities would not be prohibited from controlling other corporations.
- c) Public charities would not be restricted in their ability to incur debts, provided they would be subject to a higher disclosure requirement within their annual Registered Charity Information Return in relation to their debt obligations and be subject to intermediate sanctions if they engage in imprudent borrowing activities.
- d) Public charities would be free to use their resources either in their own charitable activities, in funding other qualified donees or any combination of these two activities.

It is believed that re-categorizing the charities into public charities and private foundations would significantly simplify the law and the regulation on registered charities. It would also provide public charities greater flexibility in their operations and enable them to better use their charitable resources in charitable activities.