National Centre on Philanthropy and the Law Annual Conference
STRUCTURES AT THE SEAM: THE ARCHITECTURE OF CHARITIES' COMMERCIAL ACTIVITIES

October 24, 2008

CANADIAN REGISTERED CHARITIES: BUSINESS ACTIVITIES AND SOCIAL ENTERPRISE – THINKING OUTSIDE THE BOX

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Carters Professional Corporation

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> What we need in addition to conventional charitable giving is a new way to think about philanthropy and the achievement of social goals. We are at a point in our nation's history where we can do this. All the elements are there. We have a history of progressive social policy. We have social entrepreneurs who are already running successful operations. We have a charitable and voluntary sector that is the second largest in the world. … The business entrepreneur improves our quality of life by creating wealth and economic growth. The social entrepreneur improves our quality of life by confronting the inequality that is often the collateral occurrence of free markets. Both kinds of entrepreneurs are necessary. Let us give them both the chance to succeed.[1]
>
> The Right Honourable Paul Martin
> Former Prime Minister of Canada

A. SOCIAL ENTERPRISE - THINKING OUTSIDE THE BOX

1. Introduction

Over the past two decades, there has been a rapid global development in the area of social enterprise.[2] As a result, governments have taken steps in enacting legislation to encourage the continued development of social enterprise. For example, in 2005, the United Kingdom enacted a new legislative framework to enable the creation of a new type of company for social enterprises known as the "Community Interest Company" or "CIC." At the time of writing this paper, there are 2097 registered CICs in the United Kingdom. In the United States, the State of Vermont passed legislation on April 30, 2008 that enables the creation of a new type of legal entity called the

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[1] The Right Honourable Paul Martin, "Unleashing the Power of Social Enterprise" (2008) vol. 21, no. 3 *The Philanthropist* 234 at 240 and 241.

“Low-Profit Limited Liability Company” or “L3C.” Similar legislation to enable the creation of L3Cs in the State of North Carolina has also been proposed.

In Canada, there has also been a rise in the interest in developing social enterprise. In a research report “Enterprising Non-Profits Program: a report on non-profits and their social enterprises, 2000-2002,” the following observations were made:

> In recent years, non-profit organizations have been looking for new ways to replace diminishing funding, diversify their funding bases, and improve organizational sustainability. At the same time, as all levels of government have withdrawn from providing many community and social services, the non-profit sector has had to step in to fill many of these gaps in services for the communities that they serve. As they are asked to do more with less, an increasing number of non-profits are exploring the creation of businesses — or social enterprises — as a way to enhance their ability to fulfill missions, create new services and programs, and generate new sources of revenue. This rise in interest in social enterprise has been accompanied by a number of initiatives, including funding programs, publications, networking organizations, and annual conferences that provide support to the growing number of social and non-profit entrepreneurs.[3]

According to a survey by The Muttart Foundation in 2006,[4] 85% of the Canadians surveyed agreed that charities should be able to earn money through any type of business activity they want as long as the proceeds go to their cause. Further, 72% of those surveyed felt that when a charity runs a business, money can get lost through the business instead of being used to help Canadians, and half (52%) felt that when charities run businesses, it takes too much time away from their core cause. Furthermore, 71% of those surveyed felt that charities that run a business as a means of fundraising should not have to pay taxes on the business income.

Furthermore, it has been observed that there has been a rise in the inter-relationship or partnerships between charities and business entities in Canada on three fronts, namely: (a) charities that are attempting to run in a more “business-like” manner, (b) charities that are developing revenue

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[2] See Canadian Centre for Social Entrepreneurship, “Social Entrepreneurship Discussion Paper No. 1”, February 2001 (online: http://www.business.ualberta.ca/ccse/Publications/publications/SE%20Discussion%20Paper-Feb2001.doc).
[3] Gannitsos, Irene, “Enterprising Non-Profits Program: a report on non-profits and their social enterprises, 2000-2002,” Enterprising Non-Profits Program, 2003.
[4] The Muttart Foundation, “Talking About Charities: 2006;” September 2006, at 8 and 9 (online: http://www.gdsourcing.ca/works/Muttart.htm).

streams through increased sales of good and services, and (c) charities that are joining forces with businesses to undertake joint marketing initiatives and cross promotions.[5]

However, until recently, there had not been any coordinated focus on issues involving social enterprises in Canada.[6] A lecture entitled "Unleashing the Power of Social Enterprise" was delivered on November 8, 2007 at the Munk Centre for International Studies, by the former Canadian Prime Minister and current Liberal MP, The Right Honourable Paul Martin. He pointed out that there is much potential to be tapped by social enterprise organizations. He commented that "social enterprises" trade goods and services and make money doing so, with their primary objective of making social or environmental return. This is what distinguishes social enterprises from for-profit corporations whose main objective is profit return, while achieving social or environmental return on an ancillary basis.[7] He further pointed out that there is still a major gap in the way the government responds to the "the real world evolution of the social economy, that of social enterprise in its fullest sense."[8] In this regard, although Canada Revenue Agency ("CRA") does permit some limited aspects of social enterprise to be conducted by registered charities, with CRA's guidelines being set out in its Guide RC4143(E), "Community Economic Development Programs,"[9] what is permitted is extremely restrictive and falls far short of the broad "social enterprise" activities that are being conducted across the global landscape.[10]

In this regard, Mr. Martin pointed out that the fundamental problem is the very clear division between charitable giving and private sector investment in Canada.[11] He stated that the problem

[5] Raymond Dart, "Charities in Business, Business in Charities, Charities and Business – Mapping and Understanding the Complex Nonprofit/Business Interface," *The Philanthropist* (2005) 18(3) 181. See an earlier research report by Brenda Zimmerman and Raymond Dart, "Charities Doing Commercial Ventures: Societal and Organizational Implications" Canadian Policy Research Networks Inc. and Trillium Foundation, 1998 (online: http://www.cprn.org/documents/12736_en.pdf).

[6] For example, a sector-wide consultation on social enterprise was held by The Muttart Foundation on April 29 to May 2, 2008, as well as special centres being dedicated to researching issues on social enterprise, such as the Canadian Centre for Social Entrepreneurship of the University of Alberta School of Business (at http://www.business.ualberta.ca/CCSE/) and the Frasier Valley Centre for Social Enterprise (at http://www.centreforsocialenterprise.com/index.html); and Enterprising Non-Profits Program (http://www.enterprisingnonprofits.ca/enp_grants).

[7] *Supra* note 1 at 234 and 235.

[8] *Supra* note 1 at 237.

[9] See *Infra* note 38 and section B1a) for a review.

[10] See section B1a) below for a review of this policy.

[11] *Supra* note 1 at 237.

lies in the fact that the *Income Tax Act* (Canada) [12] ("ITA") sets out three separate categories of sectors, namely, taxpaying corporations and individuals, tax-exempt non-profits, and charities. However, he pointed out that such a historical categorization has not kept pace with the evolution of the social domain.

This paper is not intended to propose a solution to facilitate the development of social enterprise in Canada. Instead, this paper reviews the current Canadian regime regulating business activities of charities, the driving force behind the various players in social enterprise that would need to be addressed, what lessons may be learned from the American and British development of hybrid entities for social enterprise entities, and considerations that would need to be addressed when developing a solution for Canada.

2. What is Social Enterprise?

The meaning of the term "social enterprise" varies and it appears to evolve over time, depending on the context in which this term is defined.[13] It has been pointed out that "in its most basic form, a social enterprise is a business dedicated to a social mission, or earning a profit for the financial furtherance of a social mission, although these are likely not the sole reasons for existence."[14] It is interesting to note that social enterprise is sometimes referred as the "fourth sector" as follows:

> They point to an emerging "Fourth Sector" of social enterprise organizations that combine charitable missions, corporate methods, and social and environmental consciousness in ways that transcend traditional business and philanthropy. This new generation of hybrid organizations is taking root in a fertile space between the corporate world, which is constrained by its duty to generate profits for shareholders, and the nonprofit world, which often lacks the market efficiencies of commercial enterprise.[15]

[12] R.S.C. 1985, c. 1 (5th Supp.), as amended.
[13] See Andrew M. Wolk, "Social Entrepreneurship & Government: A New Breed of Entrepreneurs Developing Solutions to Social Problems", Chapter 6 of *The Small Business Economy: A Report to the President, 2007*, Office of Advocacy of the U.S. Small Business Administration (online: www.rootcause.org). See also Roger L. Martin & Sally Osberg, "Social Entrepreneurship: The Case for Definition," *Stanford Social Innovation Review* Spring 2007.
[14] Sid Gould, "Social Enterprise and Business Structures in Canada: a Discussion", Fraser Valley Centre for Social Enterprise, February 2006 (online: www.fvcse.stirsite.com/f/SEandBusinessStructures.doc) at 5.
[15] Thomas J. Billitteri, "Mixing Mission and Business: Does Social Enterprise Need A New Legal Approach?: Highlights from an Aspen Institute Roundtable," The Aspen Institute, January 2007 (online: http://www.nonprofitresearch.org/usr_doc/New_Legal_Forms_Report_FINAL.pdf) at 2.

It has been pointed out that by blending some of the social and economic responsibilities traditionally associated with each of the three sectors, social entrepreneurship may take the form of a non-profit, business, or government initiative. However, it has also been pointed out that no matter what organizational form it takes, social entrepreneurship tends to exhibit characteristics of all three. In this regard, Andrew M. Wolk wrote:

> Like business, social entrepreneurship utilizes markets to drive innovation and productivity. Like government, social entrepreneurship responds to market failures by providing public goods and services. Like nonprofits, social entrepreneurship engages individuals in action to achieve social goals. As Nicholls concludes, "The organizational mechanisms employed are largely irrelevant: social entrepreneurs work in the public, private, and social sectors alike, employing for-profit, not-for-profit, and hybrid organizational forms (or a mix of all three) to deliver social value and bring about change." Returning to the definition, social entrepreneurship, then, is the practice of responding to market failures with transformative, financially sustainable innovations aimed at solving social problems.[16]

3. The Development of CICs in the United Kingdom

In the United Kingdom, a new legislative framework was enacted in 2005 to enable the creation of a new type of company for social enterprises, known as the "Community Interest Company" or "CIC." At the time of writing this paper, there are 2097 registered CICs in the United Kingdom.[17]

In general, CIC is a new type of limited liability company designed for social enterprises. There may be different reasons for establishing a CIC. These reasons may include: (a) working for community benefit with the relative freedom of the non-charitable company form, but with a clear assurance of not-for-profit distribution status; (b) paying directors on the board, such as a founder of a social enterprise;[18] (c) benefiting from a broader definition of community interest than the public interest test for charities; and (d) benefiting from a public perception of being identified with social enterprise.

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[16] Wolk, *supra* note 13 at 16-17.

[17] For an overview of the rules that applies to CICs, see website of the Regulator of Community Interest Companies at http://www.cicregulator.gov.uk/CIC%20guidance/Briefing%20Pack/CIC%20Briefing%20pack.pdf. See also "Fostering Social Entrepreneurship: A comparative Study" presented to Davos conference, Linklaters, January 2006.

[18] Members of the board of a charity may only be paid where the constitution contains such a power and it can be considered to be in the best interests of the charity. Therefore, in general, the founder of a social enterprise who wishes to be paid cannot be on the board and must give up strategic control of the organisation to a volunteer board, which is often unacceptable.

A CIC can be a private company limited by guarantee or by shares, or a public limited company. It can issue shares to raise capital. A CIC limited by shares can pay dividends to its shareholders, which dividend may be capped. The purpose of the dividend cap is to ensure that assets and profits of a CIC are devoted to the benefit of the community and therefore the dividends would not be disproportionate to the amount invested and the profits made by the company. CICs are taxable entities and they cannot apply to Inland Revenue for gift aid status. Deductions for tax can be made against capital expenses and the costs of running a business. A CIC that donates its surpluses to a charity will be able to deduct the amount of any such donations as a "charge" when working out its profits for corporate tax purposes.

The primary purpose of a CIC is to provide benefits to the community, rather than to the individuals who own, run or work in them. In the legislation, this core principle is achieved through the "community interest test." A company satisfies the community interest test if a reasonable person might consider that its activities (or proposed activities) are carried on for the benefit of the community. CICs are subject to an asset lock to ensure that the assets of the CIC (including any profits or other surpluses generated by its activities) are, subject to meeting its obligations, either permanently retained within the CIC and used for the community purposes for which it was formed, or transferred to another asset locked body, such as another CIC or charity.

4. The Development of L3Cs in the United States

In the United States, the State of Vermont passed legislation on April 30, 2008 that enables the creation of a new type of legal entity called the "Low-Profit Limited Liability Company" or "L3C."[19] Similar legislation creating L3Cs is pending in North Carolina and is being actively considered in Michigan, Georgia, and Montana.[20]

The L3C is a low-profit limited liability company, which is a variation of the Limited Liability Company in the United States. It is a cross between a non-profit organization and a for-profit corporation. It is designated as low-profit with charitable or educational goals. L3Cs are designed

[19] For status of the Bill, see http://www.leg.state.vt.us/database/status/summary.cfm.
[20] For an overview of the rules that apply to L3Cs, see the website of American For Community Development at http://americansforcommunitydevelopment.org/default.asp. See also "The L3C, the for profit with a non profit soul", a presentation Workshop at the UBS Philanthropy Forum, July 5-7, 2007, Lisbon, Portugal, Mannweiler Foundation Inc.

to attract program-related investments ("PRIs"). Under United States federal tax laws, private foundations must distribute 5% of their capital each year for charitable purposes. In order to meet the 5% requirement, foundations are permitted to make grants and/or make PRIs. A L3C is a for-profit entity and investments in an L3C are not deductible. L3Cs are not exempt from taxation, but the income and expenses of a L3C are allocated among the members of the L3C, reported on their returns and taxed in their hands. Its members can be individuals, government agencies, foundations, non-profits, and for-profit corporate entities. There can be different classes of investors with different levels of risk.

B. REGULATORY REGIME ON CHARITIES' BUSINESS ACTIVITIES – WHO IS THE JACK IN THE BOX?

This section of the paper reviews the Canadian regulatory regime that regulates the extent of business activities that may be conducted by registered charities. Registered charities in Canada may carry on certain business activities that are within the permitted parameters of the ITA and administrative policies and rulings of CRA.

Registered charities are required to comply with federal statutes, provincial statutes and common law. Some of the requirements that registered charities must comply with significantly limit the extent of business activities that may be conducted by registered charities. Each of these limitations is reviewed in this section of the paper.

1. Restrictions on the Operations of Registered Charities under the Income Tax Act (Canada)

Subsection 91(3) of *The Constitution Act, 1867*[21] empowers the federal government to establish the federal tax system. The ITA sets out the regulatory regime for charities, under which charities are required to be registered with the Minister of National Revenue. There are two main benefits of being registered as a registered charity. All income earned by registered charities are exempt from income tax under Part I of the ITA,[22] other than taxes under section 188 under the ITA[23] or

[21] (U.K.), 30 & 31 Victoria, c. 3.
[22] Paragraph 149(1)(f) of the ITA.
[23] If a charity's registration is revoked or if a registered charity participates in certain property transfers to avoid the application of the disbursement quota.

penalty taxes under section 188.1 under the ITA.[24] In addition, registered charities can issue donation tax receipts to their donors, providing individual donors with tax credits[25] and corporate donors with tax deductions to reduce their income.[26]

Due to the tremendous tax benefits provided to registered charities and their donors, the ITA imposes various limitations on the activities of registered charities. Some of these limitations reflect what is charitable at common law, while others reflect policies of the Canadian government in relation to how they wish charities to operate. One of these restrictions directly imposes limits on the extent of business activities that may be conducted by registered charities. Other restrictions on registered charities may also indirectly affect business activities that can be conducted by registered charities, such as disbursement requirements, borrowing restrictions, etc.

In this regard, charitable organizations and public foundations can carry on business activities that are related to their purposes (i.e. "related businesses"), but cannot engage in any unrelated

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[24] Penalty tax may be imposed on a registered charity if it carries on activities beyond the permitted parameters under the ITA, including engaging in prohibited business activities, controlling corporations beyond what is permitted under the ITA, providing undue benefits to third parties, failing to file returns, including incorrect or false information on donation receipts, making inappropriate gifts to unduly delay charitable expenditures.

[25] Individuals who made donations to registered charities may claim non-refundable tax credits pursuant to the rules set out in section 118.1 of the ITA. In general, individuals are entitled to a tax credit of 16% on the first $200 of donation, and 29% of gifts over $200, up to 75% of net income, plus 25% of certain taxable capital gains, 25% of any capital cost recapture. The change from donation deduction to donation credit for individuals was enacted in 1988 as part of the overall move to a tax credit regime. See David G. Duff, "Charitable Contributions and the Personal Income Tax: Evaluating the Canadian Credit," in *Between State and Market*: *Essays on Charities Law and Policy in Canada* (Montreal: McGill-Queen's University Press, 2001) 407-56 (online: http://www.nonprofitscan...iles/library/sm-1-8.pdf, http://www.nonprofitscan...es/library/sm-9-17.pdf, http://www.nonprofitscan.ca/Files/library/sm-0.pdf).

[26] Corporations that made donations to registered charities may claim tax deduction pursuant to the rules set out in section 110.1 of the ITA. In general, corporations may deduct charitable donations from its taxable income, up to a maximum of 75% of its net income. In addition, if the corporations donates a gift of appreciated capital property to a charity, the deduction limit would be increased by 25% of the taxable capital gain and 25% of any recapture of capital cost allowance realized on a gift of depreciable capital property (but only up to 25% of the lesser of the capital cost or the fair market value of the depreciable property). See paper by Theresa L.M. Man, "Corporate Giving: A Tax Perspective" September 18, 2006 (online: http://www.charitylaw.ca/articles.html).

businesses.[27] Private foundations, however, may not carry on any business activity.[28] CRA's guideline on related business is set out in its policy statement "What is a Related Business?" CPS-019.[29]

a) Activities that are not considered to be "business" activities (including community economic development programs)

In order for the "related businesses" restrictions to apply, the activity in question must be a "business" and the charity must be "carrying" on that business activity. Therefore, CRA recognizes that some activities are not recognized as "businesses" even though the charity involved may receive revenue from such activities. "Business" is not defined in the ITA, except that it "includes a profession, calling, trade, manufacture or undertaking of any kind whatever and … an adventure or concern in the nature of trade."[30] At common law, "business" generally refers to economic, industrial, commercial or financial activity; and "anything that occupies the time and attention and labour or a man for the purpose of profit."[31] Therefore, CRA's policy on "related business" is in relation to a "business" that involves a commercial activity undertaken with the intention to earn profit, and the charity derives revenues from providing goods or services.[32] In determining whether an activity is a business, CRA considers various factors, including whether the rationale for operating a given activity is to generate a profit, whether the activity is structured so that it is capable of earning a profit, whether the activity earned a profit in the past, and whether the person

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[27] There are three types of registered charities, namely charitable organizations, public foundations and private foundations (Subsection 248(1) of the ITA). Public foundations and private foundations are collectively referred to as "charitable foundations." (See definition for "charitable foundation", "charity", "public foundation" and "private foundation" in subsection 149.1(1) in the ITA.) These entities differ in a number of respects, including organizational form, source of funding, relationship between directors/trustees and their control by major donors, disbursement quota obligations, business activities, granting activities, borrowing activities, and control of other corporations, etc. For a detailed explanation of the differences between them, see Theresa L.M. Man and Terrance S. Carter, "A Comparison of the Three Categories of Registered Charities," *Charity Law Bulletin* No. 73, July 21, 2005 (online: www.charitylaw.ca).

[28] *Ibid*.

[29] CRA, *Policy Statement* CPS-019, "What is a Related Business?", March 31, 2003 (online: http://www.cra-arc.gc.ca/tx/chrts/plcy/cps/cps-019-eng.html). See also Arthur B.C. Drache, "Charities, Non-Profits, and Business Activities," Report of Proceedings of Forty-Ninth Tax Conference, 1997 Tax Conference (Toronto: Canadian Tax Foundation, 1998), 30:1-12; Arthur B.C. Drache, "Related Business: What's Okay and What's Not," (2005) vol. 19, no. 4 *The Philanthropist* 273; Raymond Dart, "Charities in Business, Business in Charities, Charities and Business – Mapping and Understanding the Complex Non-profit/Business Interface" (2004) vol. 18, no. 3 *The Philanthropist* 181.

[30] Subsection 248(1) of the ITA, definition for "business."

[31] Vern Krishna, *The Fundamentals of Canadian Income Tax*, 9th ed. (Toronto: Thomson Carswell, 2006), at 278. See also *Stewart Canada* [2002] 2 S.C.R. 645, [2002] 3 C.T.C. 439, 2002 D.T.C. 6969 (Eng.) (S.C.C.).

[32] *Supra* note 29, at paragraph 4.

or organization that is undertaking the activity has been selected for the position because of his/her/its commercial knowledge, skill, or experience.[33]

Although private foundations are prohibited from conducting any business activities, there is nothing to prevent them from engaging in activities which do not constitute "business" activities.

CRA recognizes that the soliciting of donations is not a commercial activity because donors do not expect any good or service in return for their contributions. CRA also recognizes that selling donated goods is not a commercial activity because businesses do not depend on donations to create their inventories; the charity does not assume the costs or level of risk usually associated with running a business; and the charity is merely converting donated assets into cash.[34]

Furthermore, registered charities are permitted to charge fees in the context of its charitable programs. CRA's policy is that the presence of fees does not necessarily mean that a program is non-charitable.[35] The mere presence of a fee charged to users of a charitable program does not confirm an intention to profit and therefore does not necessarily mean that the program is a business activity.[36] As long as a program manifests two essential characteristics, namely altruism

[33] *Ibid*.
[34] *Supra* note 29, at paragraph 5. Footnote 6 of CRA's policy indicates that "sometimes charities handle the donated goods to such an extent that more than a straight conversion of goods to cash is involved." It further indicates that "for example, a charity that receives donations of used clothing would be conducting a business if it cut up the articles and re-manufactured them to create 'new' items for sale." In *Alberta Institution on Mental Retardation v. M.N.R.* [1987] 3 F.C. 286, the organization raised funds by collecting used goods from donors and providing them to a commercial business, the Value Village, for re-sale for a profit. In return, the charity would be paid a fee and its expenses. In this regard, the court found that the solicitation for and collection of used goods by the charity was "simply a conversion of goods into money and does not itself change the nature of the appellant's operation in any way." Specifically, the court ruled that the solicitation for and collection of used goods was simply a conversion of goods into money and does not itself change the nature of the organization's operation in any way. The court rejected the argument by the Minister that the organization was "a wholesaler of goods", but found that the organization was simply converting donated goods into cash. The court in *Earth Fund* (*infra* note 68) indicated that what the organization in the *Alberta* case did was "somewhat different from the traditional fundraising activities of a foundation, but the difference is only a matter of degree."
[35] *Supra* note 29, at paragraph 6.
[36] *Supra* note 29, at footnote 7 therein. In *Re Cottam's Will Trusts*, [1955] 3 All E.R. 704, at 705: "The fact that persons have to pay something under a trust of a charitable nature does not necessarily render that trust one that is not charitable ..." In *Everywoman's Health Centre Society v. M.N.R.* (1992) D.T.C. 6001, "The Society is to be carried on an exclusively charitable basis with no intention to make a profit. ... Any surplus or charitable donations are to be used to reduce charges to patients."

and public benefit, CRA would recognize that the program is charitable.[37] CRA adopts a number of indicators in determining when a charitable program involving a fee is not a business, namely: (a) the fee structure is designed to defray the costs of the program rather than to generate a profit; (b) the program does not offer services comparable to those otherwise available in the marketplace; and (c) the fees are set according to a charitable objective as opposed to a market objective (e.g. the fees are designed to relieve poverty by being set in accordance with the users' means, or to promote broad public participation in an educational program, such as waiving admission charges to an art exhibit).

Examples of fees earned in the context of charitable programs include rent in low-income housing programs, university tuition fees, and museum admission. Other examples identified in CRA's Guide, "Community Economic Development Programs" (the "CED Guide") [38] include micro-enterprise programs, "training businesses" (which provide on-the-job training in vocational and life skills), and "social businesses" (which address the needs of people with disabilities).[39] In this regard, the CED Guide is the only CRA policy pursuant to which registered charities may carry on programs that are akin to "social enterprise" activities. However, in order for these programs to be conducted by registered charities, these programs must be operated within the restrictive limitations set out in the CED Guide, which fall far short of the broad "social enterprise" activities that are being conducted outside of Canada.

According to the CED Guide, an organization that pursues CED programs can qualify for registration as a charity if such programs involve a combination of economic and social goals, which are often interrelated. For example, economic development and commercial activities are

[37] *Supra* note 29, at footnote 8 therein. In this context, "altruism" means "giving to third parties without receiving anything in return other than the pleasure of giving." In the leading case of *Vancouver Society of Immigrant and Visible Minority Women v. M.N.R.*, [1999] 1 S.C.R. 10, the court held that "Two central principles have long been embedded in the case law. ... These two principles, namely, (1) voluntariness (or what I shall refer to as altruism, that is, giving to third parties without receiving anything in return other than the pleasure of giving); and (2) public welfare or benefit in an objectively measurable sense, underlie the existing categories of charitable purposes, and should be the touchstones guiding their further development."

[38] CRA, *Guide* RC4143(E), "Community Economic Development Programs," December 23, 1999 (online: http://www.cra-arc.gc.ca/E/pub/tg/rc4143/README.html).

[39] *Supra* note 29, at paragraph 6.

undertaken to achieve social goals (e.g. relief of poverty or empowerment of a community), while social goals (e.g. advancement of education) are undertaken to develop the local economy.[40]

The CED Guide indicates that "training businesses" are established for the purpose of giving "on-the-job training in vocational skills or more general training in work skills that enhances a person's employability." In this regard, in order for training businesses to be charitable, the dominant purpose cannot be simply to provide people with employment, or the charity with resources.[41] Under the CED Guide, micro-enterprises include the setting up in business of hard-to-employ persons as a charitable activity, which would include entrepreneurial training, support services and start-up loans.

In the CED Guide, "social businesses" takes on a very narrow meaning, referring to programs designed to address the needs of the disabled and are equivalent to sheltered workshops. Social businesses seek to provide employment on a permanent basis, unlike training businesses that provide employment for a limited period.[42] An acceptable social business may provide services or manufacture articles (such as a workshop used either by employees of the business or by individuals working for themselves, with the organization providing technical assistance, tools,

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[40] *Supra* note 38 at 4.

[41] The CED Guide, *Supra* note 38 at 6, indicates that permissible charitable training businesses typically demonstrate the following characteristics:

- classroom training occurs before or accompanies the on-the-job training;
- the participants are employed in the business for a limited period of time;
- the charity offers a job placement service to help graduates of the program find work in the labour force;
- the proportion of workers from the target population in relation to the total number of employees is no lower than 70%, but alternative ratios may be justifiable if considerable supervision is required; and
- revenues derived from the business do not substantially or consistently surpass the break-even point.

[42] In this regard, CED Guide, *Supra* note 38 at 7, takes the position that permissible charitable social businesses have the following characteristics:

- the work is specifically structured to take into account the special needs of the workers;
- the workforce is comprised entirely of people who are physically, mentally, or developmentally challenged, with the exception of a few persons with specialized skills required for operating the business;
- the workers are involved in decision-making for the organization and sit on its board to foster their sense of competence and control over their lives;
- income derived from the business may pay the workers' wages, but the organization is subsidized, usually by government grants; and
- the organization provides training that is not only immediately job-related, but which enhances the general skills of its workers.

materials, and marketing). Details on how these workshops are to be run are also prescribed in the CED Guide as follows:

> The purpose of these workshops is to provide persons working in them with the sense of self-esteem, competence, and usefulness that comes from earning an income. The products must accordingly be sold. The organization may itself operate a retail outlet or send the products to a store in a larger centre. This store, to the extent that it only accepts products produced in the programs of a number of registered charities assisting the disabled, can itself be registered as promoting the efficiency and effectiveness of these charities.[43]

Other permissible CED programs described in the CED Guide include programs for the relief of unemployment (e.g. job search assistance; helping unemployed persons obtain unemployment benefits; as well as vocational, employability, and entrepreneurial training); thrift stores and similar outlets for the poor; the sale of items made by poor artisans in third-world countries (but not in Canada) and the development of a marketing network for their products; programs relieving suffering in economically challenged communities; as well as programs that promote industry and trade for the benefit of the community. In this regard, the CED Guide defines an economically challenged community to be a community where the unemployment rate has been 50% or more above the national average for two or more consecutive years.[44]

Program related investments ("PRIs") are integral to the concept of community economic development as developed and practiced in the United States.[45] However, the CED Guide indicates that PRI has limited application for registered charities in Canada, as follows:

> Canadian tax law would require limiting the recipients of PRIs to qualified donees. Canada does not employ the expenditure responsibility concept, relying instead on specifying qualified donees to identify the organizations that can benefit from the

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[43] *Supra* note 38 at 8.

[44] CED Guide, *Supra* note 38 at 8, sets out the following examples of programs relieving suffering in economically challenged communities:

- providing affordable housing to the poor, or specially adapted housing for the aged and the disabled;
- providing community facilities, such as a hall, park, or a multi-sport recreational centre;
- providing cultural facilities, the opportunity to see artistic works, or training in the arts and crafts; and
- preserving heritage properties owned by the organization or a qualified donee such as a municipality.

[45] For a review of PRIs from the United Kingdom's perspective, see Margaret Bolton, "Foundations and Social Investment, making money work harder in order to achieve more," Esmée Fairbairn Foundation, London, October 2005); Margaret Bolton "Foundations and Social Investment in Europe Survey Report," European Foundation Centre, AISBL, Belgium, 2006. See also "Canadian Socially Responsible Investment Review 2006", The Social Investment Organization, March 2007.

> use of charitable assets. Thus, a PRI made to a qualified donee would be acceptable, while a PRI made to a non-qualified donee, such as a for-profit organization, would not.[46]

Furthermore, the CED Guide indicates that trust law would require that a charity be authorized by its objects to confer a benefit (such as a PRI) on another entity.[47] Other provincial statutes may also limit PRI in Canada, such as provincial investment statutes and the *Charitable Gifts Act* (Ontario)[48] (which limits charities in Ontario to hold no more than 10% of a business).[49] Whether a PRI may be counted toward a registered charity's disbursement quota may also be a limiting factor.[50]

b) Activities that do not amount to "carrying on" business activities

Other than activities that are not "businesses", activities that are engaged by charities that do not amount to the "carrying on" a business are also not subject to CRA's guidelines for related businesses. The ITA does not define what "carrying on" means. At common law, the phrase "carrying on" implies continuing activity.[51] CRA's policy on related business therefore indicates that "carrying on" a business implies that the commercial activity is a continuous or regular operation.[52] Therefore, a charity may engage in occasional business activities, as long as they are not conducted in a continuing nature. CRA has clarified that "on the one hand, a one-time sponsorship deal would not generally be considered to represent the 'carrying on' of a business" but "on the other hand, making sales or providing services on a regular daily or even weekly basis, with the operation requiring ongoing care and attention, would likely be viewed as 'carrying on' a business."[53] There are two types of activities that fall within this category of discussion, namely fundraising activities and investments.

CRA's position is that most fundraising activities are "business" activities, but they are usually not affected by the related business provisions because they do not amount to "carrying on" a business.

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[46] *Supra* note 38 at 13.
[47] *Ibid.* .
[48] R.S.O. 1990, c. C.8.
[49] See section B2 below on issues involving complying with provincial investment legislation.
[50] *Supra* note 38 at 13. See section B1d) below on disbursement quota requirement on registered charities.
[51] Krishna, *supra* note 31, at 1370-1371 and *Tara Exploration & Dev. Co. v. M.N.R.*, [1970] C.T.C. 557 at 567, 70 D.T.C. 6370 at 6376 (Ex. Ct.).
[52] *Supra* note 29, at paragraph 9.
[53] *Supra* note 29, at paragraph 10.

However, CRA recognizes that even if fundraising events are business activities, they would not amount to "carrying on" a business, considering that a fundraising event has clear "start" and "end" points (whereas carrying on a business implies continuous operations) and a fundraising event of a particular type does not recur with such regularity and frequency that it amounts to carrying on a business.[54] Care must be taken by charities in conducting their fundraising activities that they do not become involved in unrelated businesses that are not permitted to be engaged by charities. Examples include carefully drafting agreements before embarking on fundraising activities, such as product sales, product endorsements, and sponsorships.[55]

It is permissible for charities to derive income from appropriate passive investments. Whether an investment activity is a business activity is a question of fact. CRA's policy indicates that as long as a charity manages its investments prudently, this function would generally be regarded as a necessary administrative function and not a business activity. When distinguishing between the two, the following factors are considered: (1) Investment income is derived primarily from the mere ownership of the asset, but not dependent on active trading such as conducted by dealers who buy an asset in order to sell it as soon as possible at a profit, or the exploitation of the asset such as conducted by manufacturers or resource companies. (2) With investment income, the risk to the charity is generally limited to the purchase price of the asset. (3) Deriving investment income is also fundamentally a passive activity, in that it does not call upon the charity to take any active role in operating the underlying business.

It is important for charities to be careful to ensure that a particular involvement with an activity that is intended to be a passive investment does not inadvertently become the "carrying on" of a business. For example, CRA indicates that a charity that makes an investment by holding an interest in a partnership is considered to be carrying on a business, and is not earning passive investment income, even if the charity plays no active role in the business. This is because under the laws governing partnerships, the partner carrying on the business (general partner) is generally

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[54] *Supra* note 29, at paragraphs 11, 12 and 13. Fundraising events held in a year that are distinct in nature (e.g. a charity auction, a golf tournament, a ball, and a telethon) would be evaluated separately to determine whether it amounts to carrying on a business. However, similar events that are held repeatedly may need to be evaluated as a group to determine whether the group of events amount to carrying on a business.

[55] See examples given in an article by Jane Burke-Robertson, "Charities Carrying on Business Activities – The Legal Considerations," paper presented at the Law Society of Upper Canada seminar "Fit to be Tithed 2: Reducing Risks for Charities and Not-for-Profits" November 26, 1998.

treated as the agent of the partner providing the financing (the limited partner).[56] Since private foundations are prohibited from carrying on any business activities, an investment by a private foundation in a partnership (either as a partner or a limited partner) may be grounds for revocation for the private foundation.[57]

Although private foundations are prohibited from conducting any business activities, there is nothing to prevent them from engaging in fundraising or investment activities, which do not constitute the "carrying on" of business activities.

c) Related businesses activities

The review above indicates that a "related business" is an activity that is a "business" and involves a charity "carrying on" that business activity. The term "related business" is not defined in the ITA, except that the ITA provides that a related business includes a business that is run substantially by volunteers. When the ITA was amended in 1976 to allow, for the first time, registered charities to engage in business activities, 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. Prior to that time, the law had been administered to permit charitable organizations to operate businesses.[58] At the time, the government had reviewed the experience in the United States in taxing unrelated business income, and it decided to be silent in the Canadian legislation in defining what "related business activity" means. Therefore, it was left for CRA to establish the criteria for determining what would constitute a related business.[59]

It is important to note that the Canadian regime does not allow charities to carry on any "unrelated businesses." This approach is different from that in the United States, where income from unrelated business activities is subject to tax, whereas income from related business activities is

[56] *Supra* note 29, at paragraph 16 and footnote 10 therein.
[57] CRA document number 2006-0167421I7, June 27, 2006; document number 2000-0005475, May 10, 2000; document number 2006-0216451I7, January 19, 2007.
[58] There was an express prohibition in the case of public foundations and an implied prohibition in the case of charitable organizations.
[59] Canada, Department of Finance, *Budget Paper D: Charities under the Income Tax Act* (Ottawa: 25 May 1976) at 5. The Budget Paper was prepared following the Department of Finance's discussion paper, *The Tax Treatment of Charities* in 1975 (the "1975 Green Paper") and submissions in response to the 1975 Green Paper. See also Arthur B.C. Drache, Viewpoint "The 1981 Budget: Failure of Process?", [1982] *The Philanthropist* (Summer) 43.

exempt from tax.[60] In the United Kingdom, a destination test is applied so that as long as the profits are utilized in the organization's purposes, the profit is not subject to tax and there is no limit on the type of business activity that may be conducted by a charity.[61]

In this regard, a charitable organization is required to devote all of its resources to its charitable activities.[62] The ITA considers that this requirement would be satisfied to the extent that the charitable organization carries on a "related business."[63] Therefore, charitable organizations are permitted to carry on "related businesses." There is no express permission under the ITA for public foundations to carry on business activities. However, the ITA provides that the charitable status of public foundations may be revoked if they carry on a business activity that is not a related business.[64] Therefore, by implication, public foundations can also carry on related businesses. A charitable organization or public foundation that operates an unrelated business may be subject to a penalty of 5% of their gross revenue from such business activities. A repeat offence within 5 years of the first infraction will carry a monetary penalty equal to all of the charity's gross revenue from the offending activities, as well as a suspension of its ability to issue tax receipts,[65] or even revocation of its charitable status.[66]

There are two kinds of related businesses: (a) one that is linked to a charity's purpose and subordinate to that purpose, and (b) one that is run substantially by volunteers.[67]

In relation to a related business that is linked to a charity's purpose and subordinate to that purpose, it is a question of fact whether or not these tests are met. The fact that the profits from a business

[60] Bruce R. Hopkins, *The Law of Tax-Exempt Organizations*, 9th ed., (New Jersey: John Wiley & Sons, Inc. 2007) at 720-722, 835-836.
[61] Peter Luxton, *The Law of Charities* (New York: Oxford University Press Inc., 2001) at 732.
[62] See paragraph (a) of the definition for "charitable organization" in subsection 149.1(1) of the ITA.
[63] Paragraph 149.1(6)(a) of the ITA provides that a charitable organization is considered to be devoting its resources to its charitable activities to the extent that it carries on a related business.
[64] Paragraph 149.1(3)(a) of the ITA.
[65] Subsections 188.1(1), 188.1(2), and 188.2(1) of the ITA.
[66] Subsection 149.1(2) of the ITA.
[67] *Supra* note 29, at paragraph 17.

are applied to a charitable purpose is not sufficient to constitute the necessary linkage.[68] Instead, it is the nature of the business, and whether it has some direct connection to a charity's purpose, that determines whether it is a related business.[69] In this regard, CRA's policy recognizes four forms of connection or linkage, so that a business will be considered linked to a charity's purpose if it fits within one of the following four categories:[70]

(1) A usual and necessary concomitant of charitable programs[71] – These are business activities that supplement a charity's charitable programs, either because they are "necessary for the effective operation of the programs," or they "improve the quality of the service delivered in these programs." For example, a hospital's parking lots, cafeterias, and gift shops for the use of its patients, visitors and staff; as well as university book stores or student residences.

(2) An off-shoot of a charitable program[72] – In the ordinary operation of a charity's charitable program, a charity may create an asset that it can exploit in a business, i.e. the charity carries out its charitable programs, not in order to create the asset, but to achieve its charitable purpose. The asset is simply a by-product of the charity's programs. For example, a church sells recordings of its special Christmas services hosted by its famous choir at as high a price as it can obtain.

(3) A use of excess capacity[73] – This type of business involves "using a charity's assets and staff, which are currently needed to conduct a charitable program, to gain income during periods when they are not being used to their full capacity within the charitable programs." For example, a university renting out its residence facilities in the summer months when they are not required for

[68] *Supra* note 29, at paragraph 5 and footnote 6 therein. See *Earth Fund v. M.N.R* (2002) F.C.A. 498, 2004 D.T.C. 6140 (F.C.A.). In *Earth Fund*, the court (at paragraph 30) did not "accept the argument of counsel for the appellant that the *Alberta Institute* case is authority for the proposition that any business is a 'related business' of a charitable foundation if all of the profits of the business are dedicated to the foundation's charitable objects." At paragraph 31, the court found that the organization proposed to do nothing except market and sell lottery tickets "in a manifestly commercial arrangement that will, if all goes as planned, result in a profit that will be donated … to qualified donees" and therefore the organization "is in exactly the same position as any commercial enterprise that commits itself to apply its profits to charitable causes." As such, the court found that "such a commitment, by itself, does not derogate from the commercial nature of the activity that generates the profit" and therefore agreed that the organization's "proposed lottery operation would be a business of the appellant that is not a 'related business', and thus would not qualify as a charitable activity."
[69] *Supra* note 29, at paragraph 20.
[70] *Supra* note 29, at paragraph 21.
[71] *Supra* note 29, at paragraphs 22 and 23.
[72] *Supra* note 29, at paragraphs 24 and 25.
[73] *Supra* note 29, at paragraphs 26 to 29.

use by the students, or a church renting out unused parking spaces during the week when it is not being used by the church.

(4) The sale of items that promote the charity or its objects[74] – This type of business activity involves "sales that are intended to advertise, promote, or symbolize the charity or its objects." A product may serve this promotional purpose by virtue of its design, packaging, or included materials. Usually, the items are bought by those who want to contribute to the work of the charity, and they do not compete directly with products produced and sold by for-profit entities. Examples would include the sale of pens, credit cards, and cookies that clearly display the charity's name or logo, and T-shirts or posters depicting the work of the charity.

Even if a business is linked to a charity's purpose, CRA requires that it must also be subordinate to that purpose. When determining whether a business is subordinate to a charity's purpose, CRA requires that it "remains subservient to a dominant charitable purpose, as opposed to becoming a non-charitable purpose in its own right."[75] In this regard, CRA considers four relevant factors in looking at the business activities in the context of the charity's operations as a whole: (a) relative to the charity's operations as a whole, the business activity receives a minor portion of the charity's attention and resources; (b) the business is integrated into the charity's operations, rather than acting as a self-contained unit; (c) the organization's charitable goals continue to dominate its decision-making; and (d) the organization continues to operate for an exclusively charitable purpose by, among other things, permitting no element of private benefit to enter in its operations.

The second type of related business is a business that is run substantially by volunteers.[76] The term "related business" is defined in the ITA to "include" a business that is unrelated to the objects of the charity if it is run substantially by volunteers.[77] CRA interprets this to require that at least 90% of those engaged in the business activity are serving as unpaid volunteers.[78] When calculating the percentage of volunteers involved in the business, CRA takes the position that people "employed" in the business means the people the charity "uses" to operate the business, and includes those

[74] *Supra* note 29, at paragraph 30.
[75] *Supra* note 29, at paragraph 31.
[76] See definition for "related business" in subsection 149.1(1) of the ITA.
[77] *Ibid*.
[78] *Supra* note 29, at paragraph 18.

working for the charity under contract as well as the charity's direct employees.[79] Therefore, it would imply that as long as a business is substantially run by volunteers of a charity (on the basis of a head count, regardless of whether they are full time or part time[80]), the charity can engage in any type of business activity, regardless of the scale of the activity.

Unless a business can be run substantially by volunteers, the types of business activity that can be operated by charitable organizations and public foundations are fairly limited. However, depending on the nature of the charity and the business activity, it may not be possible to have a business activity be run substantially by volunteers. Therefore, charities often have to find other means to achieve what they wish to achieve. In this regard, CRA suggests that a charity may establish a separate taxable company to operate the unrelated business activity.[81] Other alternatives involving intermediaries may also be utilized by charities, such as non-profit organizations and business trusts. These alternative options are reviewed in section C below.

d) Other limitations

Other than the restrictions imposed by the ITA and CRA on the extent of business activities that may be conducted by registered charities, other requirements imposed by the ITA and CRA on the activities of registered charities may also directly restrict the ability of registered charities to engage in business activities, even though they may be related businesses. The following are examples of key restrictions in this regard.

Legal structure – Registered charities can carry on activities using a variety of legal structures, including unincorporated associations, corporations, and trusts. The types of legal structure that can be utilized by register charities will depend on the type of registered charity. Charitable organizations can be organized as unincorporated associations, corporations, or trusts,[82] while charitable foundations can be organized as corporations or trusts.[83] Registered charities cannot be organized as partnerships. Therefore, when establishing a new charity that intends to carry on certain business activities in conjunction with other entities, care must be taken that it is not

[79] *Supra* note 29, at paragraph 19.
[80] This is based on a telephone conversation, in 2008, between the authors and senior CRA officials.
[81] *Supra* note 29, at paragraphs 47 and 48, as well as footnotes 14 and 15 therein.
[82] See definition for "charitable organization" in subsection 149.1(1) in the ITA.
[83] See definition for "charitable foundation" in subsection 149.1(1) in the ITA.

organized as a partnership. Otherwise, it would not qualify for charitable registration. Another interesting point is that registered charities are usually membership based non-share capital corporations. However, it is possible for share capital corporations to be registered as registered charities as well, such as in the province of Alberta. In those situations, CRA requires shares to be of nominal or par value and prohibits the transfer of shares for profit.

Interest in a partnership – A partnership does not have a separate legal personality, both at common law or civil law. Therefore, under the ITA, a partner of a partnership derives his/her income from the activities of the partnership itself, not from property (the interest in the partnership), and the interest expenses incurred by that partner to finance his/her contribution are incurred to obtain that business income (or income from property held by the partnership). Therefore, if a charity is a partner of a partnership, it is recognized to be carrying on a business. This would still be the case even where a charity is a limited partner of a partnership. This is because even though the limited partner takes no part in the management of the business, it does not mean that it and the other limited partners do not carry on that business in conjunction with the general partner(s).[84] Therefore, for a charity that wishes to be involved in a business activity that operates through a partnership, care must be taken that in the event that the charity becomes a partner of the partnership, the business operated by the partnership would not be recognized as an unrelated business of the charity.

Disbursement quota – All registered charities are required to expend a portion of its assets annually in accordance with a disbursement quota, which 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.[85] Failure to comply with the disbursement quota may result in the imposition of interim penalty sanctions on the charity, or even the loss of its charitable status.

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[84] *Trustee of Robinson v. The Queen*, 98 D.T.C. 6065 (F.C.A.). The court in *Gordon Grocott v The Queen*, 96 D.T.C. 1025, stated that "A limited partner is nonetheless a partner in a partnership. It is simply that his liability is limited by statute provided that he does not participate in running the business. I do not think it can be said that this limitation of liability and prohibition against any active part in the control of the business means that he is not carrying on business through the partnership." See also *supra* note 57.
[85] See CRA, *Information Circular* RC 4108, "Registered Charities and the Income Tax Act," updated May 7, 2002 (online: http://www.cra-arc.gc.ca/E/pub/tg/rc4108/README.html).

The calculation of the disbursement quota generally consists of two parts, an 80% disbursement quota and a 3.5% disbursement quota.[86] Only monies spent directly on charitable activities or on gifts to qualified donees[87] would be counted towards meeting the disbursement quota. However, expenditure on operating a business activity or a fundraising activity would not be included.[88] Therefore, a charity must be careful that its expenditure on business activities would not cause the charity to not meet its disbursement quota requirements.

Restrictions on fundraising – CRA recently released a proposed policy on "Fundraising by Registered Charities" on June 20, 2008,[89] which imposes new restrictions on the fundraising activities of registered charities, as well as the amount of expenditure that could be spent on fundraising activities. Public consultation of this proposed policy closed on August 31, 2008.[90] Although this proposed policy addresses fundraising activities rather than business activities, it is important for charities to carefully review the application of this proposed policy to determine whether what is intended to be business activities from the perspective of the charities may be recognized as fundraising activities and therefore be subject to this draft policy.

Restriction on borrowing by foundations – Charitable foundations (i.e. both public and private) are prohibited from incurring debts other than debts for current operating expenses, the purchase and

[86] A detailed review of the calculation of the disbursement quota is outside the scope of this paper. For details, see paper by M. Elena Hoffstein and Theresa L.M. Man, "New Disbursement Quota Rules under Bill C-33," paper presented at the Canadian Bar Association/Ontario Bar Association 3rd National Symposium on Charity Law, May 6, 2005 (online: www.charitylaw.ca).

[87] 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, registered Canadian amateur athletic associations, certain low-cost housing corporations for the aged, municipalities, provincial and federal governments, the United Nations and its agencies, prescribed universities outside Canada, charities outside Canada to which the federal government has made a gift in the past year, and registered national arts service organizations. In February 2004, it was proposed to amend sections 110.1 and 118.1 of the Act by including municipal or public bodies performing a function of government in Canada. This proposed amendment has been brought forth and was previously included in Bill C-33 in November 2006, which died on the Order Paper since the federal Parliament was prorogued on September 14, 2007. The proposed amendment was again re-introduced in Bill C-10 on October 29, 2007. Bill C-10 again died following the dissolution of the federal Parliament on September 7, 2008.

[88] *Supra* note 29, at paragraph 8. See also CRA's proposed policy "Fundraising by Registered Charities", June 20, 2008, (online:http://www.cra-arc.gc.ca/tx/chrts/cnslttns/fndrsng-eng.html).

[89] *Ibid*.

[90] For an overview of the draft fundraising policy, see article by Theresa L. M. Man and Terrance S. Carter "Be Careful What You Ask For: CRA Proposed Policy On Fundraising", *Charity Law Bulletin* No. 142, August 5, 2008 (online: www.charitylaw.ca).

sale of investments,[91] or the administration of the charitable activities. Incurring such debts by charitable foundations could be cause for revocation of their charitable status.[92] The inability of a foundation to incur debts may seriously impair its ability to engage in related businesses.

Restriction on control of corporations by charitable foundations – Charitable foundations cannot acquire control of any corporation. Control usually means that the foundation owns, or the foundation plus persons not dealing with it at arm's length own, more than 50% of a corporation's issued share capital with full voting rights.[93] Failure to comply with the prohibition requirement would be grounds for the imposition of penalty tax equal to 5% tax on dividends paid to the foundation, and would be increased to 100% tax on dividends paid to the foundation on a repeat infraction within 5 years.[94] Furthermore, the foundation's charitable status may also run the risk of being revoked.[95] For the purpose of revocation, a charitable foundation would be deemed not to have acquired control provided it has not purchased or otherwise acquired for consideration more than 5% of any class of shares of the corporation. Therefore, a gift of shares, regardless of the percentage, will not result in a foundation being considered to control a corporation, and it would not risk revocation as long as it does not acquire more than 5% of the shares for consideration.

No business activities by private foundations – There are many reasons that have made private foundations attractive, e.g. as a vehicle to accomplish the philanthropic objectives of high net-worth individuals. One of the most attractive features of a private foundation is that the board of directors of a private foundation does not need to deal at arm's length with the donor, and therefore the donor can remain in control of the foundation and the gifted property.[96] However, private foundations are prohibited from engaging in any business activities.

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[91] Such debts may include miscellaneous types of debt, such as brokerage fees or other incidental amounts that could relate either to the purchase or the sale, as well as debts incurred by charitable foundations for the purpose of acquiring investments are acceptable debts. See CRA, document number 2005-0154751I7, October 21, 2005.
[92] Paragraphs 149.1(3)(d) and 149.1(4)(d) of the ITA.
[93] Subsection 149.1(12) of the ITA, "control."
[94] Subsection 188.1(3) of the ITA.
[95] Paragraph 149.1(3)(c) and 149.1(4)(c) of the ITA.
[96] For a review of various reasons for establishing and giving to a private foundation and a review of the rules under the ITA that apply to private foundations, see article by Maria Elena Hoffstein, "Private Foundations and Community Foundations", paper presented at the Canadian Tax Foundation Fifty-Ninth Annual Tax Conference, November 25-27, 2007.

Excess corporate holdings rules - Furthermore, private foundations are also subject to newly enacted excess corporate holding rules, which require shareholdings of a class of shares over 2% be subject to public disclosure reporting, and shareholdings of a class of shares over 20% be divested by the foundation.[97] Therefore, it would prevent a donor who is a social entrepreneur to engage his/her private foundation in any business activities.

2. Restrictions on the Operations of Charities under Provincial Statutes

Other than the various restrictions imposed on registered charities under the ITA, there are various restrictions on charities under provincial statutes, which may also affect the extent to which charities may carry on business activities, such as business holdings, fundraising, land holdings, investments, etc. In this regard, under subsections 92(7)[98] and 92(13)[99] of *The Constitution Act, 1867*, many aspects of charities' operations are within provincial jurisdiction. These statutes vary from province to province. The following are examples of some of them.

One of the most unusual and biggest hurdles is the restrictions imposed by the *Charitable Gifts Act* (Ontario)[100] on charities owning more than 10% of an "interest in a business."[101] Therefore, a charity may invest in a business as a minority shareholder, but would not be permitted to own an interest in excess of 10%. If the charity is found to own more than 10% of the shares of a business, it would have to dispose of any interest in excess of 10% of the interest within 7 years, although it is possible to obtain a court order to extend the 7-year period. In addition, where ownership of an interest in a business represents more than 50%, subsection 4(1) of the *Charitable Gifts Act* requires that financial statements of the business and other financial information be filed with the Ontario Public Guardian and Trustee ("PGT"), the provincial body responsible for the oversight of

[97] For an overview of the excess corporate holdings rules, see article by Karen J. Cooper and Terrance S. Carter, "Federal Budget 2007 Highlights For Charities," *Charity Law Bulletin* No. No.113, March 29, 2007 (online: www.charitylaw.ca).; Theresa L.M. Man and Terrance S. Carter, "Federal Budget 2008 - Highlights For Charities," *Charity Law Bulletin* No. 135, February 27, 2008 (online: www.charitylaw.ca).

[98] Subsection 92(7) establishes provincial legislative jurisdiction in respect of "the establishment, maintenance and management of hospitals, asylums, charities and eleemosynary institutions ..."

[99] Subsection 92(13) establishes provincial legislative jurisdiction in respect of "property and civil rights in the province."

[100] *Supra* note 48.

[101] Specifically, section 2(1) of the *Charitable Gifts Act* (Ontario) provides as follows:

> 2.(1) Despite any general or special Act, letters patent, by-law, will, codicil, trust deed, agreement or other instrument, wherever 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, such person has power to dispose of and shall dispose of such portion thereof that represents more than a 10 per cent interest in such business.

charitable property, by March 31st of each year, and that the amount of profits to be distributed be determined jointly with the PGT and paid to the charity in the same year on or before June 30th. Subsection 2(2) of the *Charitable Gifts Act* provides that the prohibition in subsection 2(1) does not apply to an organization of any religious denomination. Subsections 2(4) and (5) of the *Charitable Gifts Act* provide a vague and broad statutory definition of "interest in a business."[102] Apart from this statutory definition, there is little assistance from case law and no commentary on the issue of what constitutes an "interest in a business."

The exact scope of the application of the prohibition is difficult to ascertain given the paucity of case law, and the fact that the terms of the *Charitable Gifts Act* are much broader in scope than the legislative debates at the time of its initial enactment would otherwise suggest. As such, although the justification for the *Charitable Gifts Act* was narrowly focused on protecting the revenue and saving charities from possible abuse,[103] the scope of its prohibition is extremely broad. This limited caselaw available on point and the PGT's position suggest that despite the original intention of the statute, and the fact that the statute suggests that an acquisition (as opposed to a gift) is exempted from the application of the divestiture rules, the courts and the PGT's office are not concerned with how the interest in the for-profit business is acquired. In this regard, the Ontario Court of Appeal in *Ballard Estate v. Ballard Estate*[104] held that the "purpose of the *Charitable Gifts Act* is to prevent charitable corporations or trusts, other than religious institutions, from

[102] Subsection 2(4) and (5) of the *Charitable Gifts Act* (Ontario) provides as follows:

> 2(4) For the purposes of this Act, a person shall be deemed to have an interest in a business,
> (a) if the person is a part owner of the business;
> (b) if the person holds or controls, directly or indirectly through a combination or series of two or more persons, one or more shares in a corporation that owns or controls or partly owns or controls the business; or
> (c) if the person holds or controls, directly or indirectly through a combination or series of two or more persons, one or more bonds, debentures, mortgages or other securities upon any asset of the business.
> 2(5) For the purposes of this Act but subject to subsection (3), an interest in a business shall be deemed to be given to or vested in a person for a religious, charitable, educational or public purpose so long as the interest or the proceeds thereof or the income therefrom is to be used for any such purpose at any time and even though before any such use is made thereof the interest or the proceeds thereof or the income therefrom is to pass into or through the hands of one or more persons or is subject to a life or other intermediary interest.

[103] *Hansard*, March 25, 1949 ¶ 1338. Parliamentary records indicate that the statute was originally intended to apply to charitable trusts and foundations (not charitable organizations) in order to assure that assets exempted from succession duties on the grounds that they are being devoted to charitable purposes "shall in fact be devoted to charitable purposes, and shall not be devoted to purposes in which charity is secondary. […] [The bill] desires to encourage charitable trusts and foundations, but desires them to be such and not merely charitable trusts and foundations as a cloak for something else." The records also indicate that it was intended that a charitable trust or foundation could turn over its interest in businesses to "established charitable organizations" who would "constantly exercise the proper security of the operations of the business because of their interest in its profits."

[104] (1991), 3 O.R. (3d) 65 (C.A.).

owning, holding or controlling, directly or indirectly, more than a ten per cent interest in a business that is carried on for profit or gain."[105] The court further held that the "legislation is aimed at ensuring that charities are not used as a means of sheltering a business enterprise, that is to say, of creating a situation where the tax privileges conferred upon charities are employed as a means of building up a business, or otherwise sustaining it."

CRA suggests that a charity may establish a separate taxable company to operate unrelated business activity, such as a for-profit company. However, the restrictions imposed by the *Charitable Gifts Act* and the broad interpretation of its applications seriously impair the ability of charities in Ontario to utilize this option.

Another restriction imposed by provincial statutes is the requirement that charities must invest their assets pursuant to certain standards. The standard imposed varies from province to province.[106] For example, charities that are incorporated in Ontario, have offices in Ontario, or invest charitable funds in Ontario, generally have to comply with the new investment provisions of the *Trustee Act* (Ontario).[107] The 1999 amendments to the *Trustee Act* established a prudent investment standard governing investment decision-making of trustees or board of directors of charities, while the 2001 amendments now permit charities to delegate their investment decision making to qualified investment advisers under certain circumstances. Specifically, subsection 27(1) of the *Trustee Act* states that a trustee "must exercise the care, skill, diligence and judgment that a prudent investor would exercise in making investments." Based on the standard of care of a prudent investor, subsection 27(2) states that a trustee "may invest trust property in any form of property in which a prudent investor might invest." Although the *Trustee Act* does not define what is meant by a "prudent investor," subsection 27(5) states that a trustee must consider a number of criteria in the planning of investment of trust property, in addition to any others that are relevant in

[105] Ibid, at 76.
[106] For an overview of the various provincial statutes, see paper by Linda J. Godel, "Investment Powers for Charities Across Canada"paper presented at the Canadian Bar Association/Ontario Bar Association 2nd National Symposium on Charity Law, April 14, 2004.
[107] R.S.O. 1990, c. T.23.

the circumstances.[108] In addition, subsection 27(6) of the *Trustee Act* states that a trustee must diversify the investment of trust property to an extent that is appropriate to the requirements of the trust, as well as general economic and investment market conditions.

Therefore, charities must ensure that the business interests they hold comply with the standard imposed by provincial statutes. Where the standard imposed by provincial statutes is too high or is not complementary to the environment in which business activities are conducted, the ability of charities to engage in business activities would also be impaired.

A further restriction imposed by provincial statutes involves the prohibition of a charity in Ontario from holding real property for over three years and not using it for its own use or occupation pursuant to the *Charities Accounting Act* (Ontario).[109] Specifically, if a charity holds property for a period of over three years and during which time, the property has not been used or occupied by the charity, and is not required for the use or occupation by the charity now or in the immediate future, then the PGT may vest the property in itself, and then sell the property and use the sale proceeds for the charitable purposes of the charity in question.[110] However, the PGT administratively permits non-charitable ancillary and incidental use of land owned by a charity, as long as such space is generally less than 20% of the total area. If it is over 20%, it is not clear whether the PGT will exercise its discretion to vest the property, and this will have to be decided on a case-by-case basis. Therefore, this restriction would limit the ability of charities to lease out

[108] The criteria are: general economic conditions; the possible effect of inflation or deflation; the expected tax consequences of investment decisions or strategies; the role that each investment or course of action plays within the overall trust portfolio; the expected total return from income and the appreciation of capital; needs for liquidity, regularity of income and preservation or appreciation of capital; and an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.

[109] R.S.O. 1990, c. C.10.

[110] Subsection 8(2) of the *Charities Accounting Act* (Ontario) provides as follows:

> 8(2) Where in the opinion of the Public Guardian and Trustee, land held for a charitable purpose,
> (a) has not been actually used or occupied for the charitable purpose for a period of three years;
> (b) is not required for actual use or occupation for the charitable purpose; and
> (c) will not be required for actual use or occupation for the charitable purpose in the immediate future,
> the Public Guardian and Trustee may vest the land in himself or herself by registering a notice in the land registry office to that effect and stating that the Public Guardian and Trustee intends to sell the land, and shall, where practicable, deliver a copy of the notice to the person who held the land for the charitable purpose.
> 8(3) Where land vests in the Public Guardian and Trustee under subsection (2), the Public Guardian and Trustee shall cause the land to be sold with all reasonable speed and shall apply the proceeds of sale, less his or her reasonable expenses in respect of the sale, to the charitable purpose.

surplus real estate for an income stream for over three years, or develop surplus land for commercial use in return for an income stream.

Four provinces (namely Alberta, Saskatchewan, Quebec and Prince Edward Island) have legislation governing charitable fundraising activities, which generally require registration by entities with a charitable purpose. These various provincial charitable fundraising statutes vary in their content and application. For example, in Alberta, the *Charitable Fund-raising Act* (Alberta)[111] requires a charitable organization, as a result of solicitations, that receives gross contributions in its financial year of $25,000 or more from individuals and/or others in Alberta to register within 45 days of the gross contributions reaching $25,000.[112] Furthermore, charitable organizations that use the services of a "fundraising business" that receives payment for making or managing solicitations made on behalf of the charitable organization are also required to register under that statute.[113] A detailed review of these statutes is outside the scope of this paper.[114] However, it is important to note that these fundraising statutes are different from CRA's proposed fundraising policy. CRA's position is that its proposed policy on fundraising is a result of CRA being a regulator of a tax regime that grants registration and oversees the operations of charities based on principles at common law of what is charitable.[115] Since the area of fundraising falls under provincial jurisdiction pursuant to *The Constitution Act*, *1867*, the jurisdiction of CRA to regulate the area of fundraising in its proposed policy has been questioned.[116]

Although these statutes address fundraising activities rather than business activities, it is important for charities to carefully review the application of these fundraising statutes to determine if intended business activities from the perspective of the charities, which would be assumed to fall outside the scope of these provincial statutes, would actually be recognized as fundraising activities and therefore require compliance with these statutes. Furthermore, if the business

[111] R.S.A. 2000, c. C-9.
[112] Subsections 12(3) and 12(4) of the *Charitable Fund-raising Act* (Alberta).
[113] Section 13 of the *Charitable Fund-raising Act* (Alberta).
[114] For an overview of the requirements of these statutes, see a paper by Esther S.J. Oh and Jacqueline M. Connor, "Extra-Provincial Corporate and Fundraising Compliance For Charities", paper presented at the Canadian Bar Association/Ontario Bar Association 2nd National Symposium on Charity Law, April 14, 2004 (online: www.charitylaw.ca).
[115] *Supra* note 88 at section 3.
[116] *Supra* note 90 at 13-14.

activities somehow fall within these statutes, the charities would need to determine whether these statutes may restrict the ability of the charity to carry on those activities.

3. Restrictions on the Operations of Charities at Common Law

Eligibility for registration under the federal income tax regime is based on meeting the common law definition of charity, as developed through the courts. In order to be recognized as a charity, the applicant must be established under one or more of the four heads of recognized charitable purposes at common law, namely relief of poverty, advancement of education, advancement of religion, or other purposes beneficial to the community in a way the law regards as charitable.[117] It is possible for charities to be established to carry out activities under only one of these heads of charitable objects. It is also possible for charities to carry out activities under more than one of these objects.

In addition, charities are also required to comply with other common law requirements. Some of these requirements may also impair the ability of charities to engage in business activities.

One of the common law requirements that apply to charities is the prohibition of remuneration of directors of charities. Directors of a charity are considered to be quasi-trustees for the purposes of managing and investing the charitable property of a charity, and therefore they are prohibited at common law from receiving any direct or indirect benefit from the charity.[118] As a result, charities cannot pay directors any form of remuneration for services rendered without court approval of the payment of remuneration, even though the services are provided at a reasonable or below market cost. This is because directors of charities are considered to have trustee-like fiduciary obligations placed on them in relation to charitable property and, as a result, it would be a conflict of interest, as well as a breach of trust, for a charity to pay any monies of the charity to any director as remuneration for any services rendered by the director to the charity, whether it is in his/her

[117] See the definition set out by Lord Macnaghten in *Commissioners for Special Purposes of the Income Tax Act v. Pemsel*, [1891] A.C. 531 at 583, [1891-1894] All E.R. Rep. 28 at 55 (H.L.): "'Charity' in its legal sense comprises four principal divisions: trusts for the relief of poverty; trusts for the advancement of education; trusts for the advancement of religion; and trusts for other purposes beneficial to the community, not falling under any of the preceding heads."
[118] See for example: *Re French Protestant Hospital,* [1951] Ch. 567; *Ontario (Public Guardian and Trustee) v. AIDS Society for Children (Ontario),* [2001] O.J. No. 2170 (Sup. C.J.); *Re Public Trustee and Toronto Humane Society* (1987), 40 D.L.R. (4th) 111 (Ont. H.C.J.); *Re David Feldman Charitable Foundation* (1987), 58 O.R. (2d) 626 (Surr. Ct.); *Ontario (Public Guardian and Trustee) v. National Society for Abused Women and Children*, [2002] O.J. No. 607 (Sup. C.J.); *McLennan v. Newton* (1927), [1928] 1 D.L.R. 189 (Man. C.A.).

capacity as a director or for other services provided to the charity. In addition, the Ontario PGT makes it clear that directors of charities have a duty to avoid conflict of interest situations, as well as the appearance of a conflict of interest.[119] As a result, directors of charities operating in Ontario are precluded from receiving remuneration for serving as a director, and also are precluded (together with any family members that the said director financially supports or is financially supported by) from being paid employees of the charities in which they serve.

Such a requirement would prohibit a social entrepreneur from engaging his/her charity in business activities, because the social entrepreneur would either have to give up control of the charity by not sitting on the board, and be limited to being a paid employee or a volunteer director.

C. USE OF INTERMEDIARY ENTITIES – ANYONE ELSE IN THE BOX?

The previous section of this paper shows that the current regulatory regime is very restrictive on registered charities' ability to engage in business activities. In order to overcome some of the restrictions imposed on registered charities in Canada, charities have utilized intermediary entities as a means to carry on business activities that would otherwise not be permissible to be conducted by the charities themselves. Such an arrangement would involve continuing to operate the charitable programs through the registered charity, while compartmentalizing the operations of the business activity in an intermediary entity. Examples of intermediary entities would include a for-profit company, a non-profit corporation, a business trust, or combinations of these entities. The intermediary would be operated on a parallel basis with the registered charity, with profits earned by the intermediary from the business operation being used for the benefit of the registered charity. Each of these options has pros and cons, and has its own limitations. Care must be taken in structuring and implementing these arrangements in order to ensure that the objectives are achieved.[120]

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[119] See PGT's Charities Bulletin #3 (Online: http://www.attorneygeneral.jus.gov.on.ca/english/family/pgt/charbullet/bullet3.asp).

[120] See for example, Arthur B.C. Drache, "Charities, Non-Profits, and Business Activities," Report of Proceedings of Forty-Ninth Tax Conference, 1997 Tax Conference (Toronto: Canadian Tax Foundation, 1998), 30:1-12; Arthur B.C. Drache, "Related Business: What's Okay and What's Not." (2005) vol. 19, no. 4 *The Philanthropist* 273; and Jane Burke-Robertson, "Charities Carrying on Business Activities – The Legal Considerations," paper presented at the Law Society of Upper Canada seminar "Fit to be Tithed 2: Reducing Risks for Charities and Not-for-Profits" November 26, 1998.

1. For-Profit Company

One option is to incorporate a for-profit business share capital corporation which would operate the business or own revenue generating real property, and an arrangement would be made in relation to the shareholdings of the for-profit company so that the charity would maintain control or influence over the shareholders.

If the charity is in Ontario, and if the for-profit company was to hold title to a revenue generating real property, this option would allow the charity to avoid the 3-year limitation period imposed by the *Charities Accounting Act* (Ontario) and allow the real property to be held for a longer period of time, subject to the comments set out below concerning the *Charities Accounting Act*, even if it was not occupied or used by the charity for its charitable purposes. Profits earned by the for-profit company may be paid to the charity as donations from its pre-tax profits, therefore reducing the tax liability of the for-profit company. In addition, after tax profits of the for-profit company can be paid to the charity as dividends, since the charity would be the sole shareholder of the for-profit company. In order to protect the interest of the charity and its right to be paid dividends from time to time, and to prevent the board of directors of the for-profit company from refusing to declare dividends, it is possible to require the for-profit company to develop a policy on the declaration of dividends, with the policy being subject to the approval of the charity.

However, there are a number of concerns that arise from this option:

a) Tax liability – Income Tax Act (Canada)

The for-profit company is a taxable entity and would have to pay tax on its taxable income. As indicated above, the pre-tax profits of the for-profit company may be donated to the charity, thereby reducing the tax liability of the for-profit company. A corporation may deduct the eligible amount of gifts made to qualified donees in the year or in the preceding 5 years.[121] In general, the for-profit company is entitled to a tax deduction from its taxable income, up to a maximum of 75% of its net income. In addition, if the for-profit company donates a gift of appreciated capital property to a charity, the limit is increased by 25% of the taxable capital gain and 25% of any

[121] Paragraph 110.1(1)(a) of the ITA. This provision does not apply to gifts made to Her Majesty, gifts of cultural property and ecological gifts because they are dealt with under paragraphs 110.1(1)(b), (c) and (d).

recapture of capital cost allowance realized on a gift of depreciable capital property (but only up to 25% of the lesser of the capital cost or the fair market value of the depreciable property).

Therefore, when the for-profit company makes a donation to the charity during a year, it will receive a donation receipt from the charity, which can be used to deduct up to 75% of the income of the for-profit company, and therefore reduces the tax liability of the for-profit company. When the for-profit company sells its interest in the property, it can donate the sale proceeds to the charity or it can donate the real property to the charity as an in-kind gift, and receive a donation receipt from the charity for the gift, thereby reducing the tax liability of the charity on the disposition of the property.

In the event that the charity provides services or resources to the for-profit company, e.g. bookkeeping or personnel, the charity would need to charge reasonable fair market payments between arm's length parties. Such arrangements would need to be in writing, e.g. by means of a service contract between the two entities. The payments would be deductible business expenses for the for-profit company, provided that they are reasonable bona fide payments necessary for the for-profit company to earn income. The making of such payments would reduce the net profit of the for-profit company and tax payable by the for-profit company. In the event that the for-profit company has a shortfall from its operations, the charity would not be able to gift or utilize its resources for the benefit of the for-profit company. Instead, the charity may loan the required funds to the for-profit company, to be secured (e.g. by a collateral mortgage) and repaid by the for-profit company in the future.

b) Interest in a business - Charitable Gifts Act (Ontario)

If the charity was to be the sole shareholder of the for-profit company, the charity would be holding 100% of the business interest. The limitation imposed by the *Charitable Gifts Act* (Ontario) would apply and the charity would be required to dispose of at least 90% of its interest in the business within 7 years and to make annual reports to the PGT. Therefore, the viability of using a for-profit company as an intermediary entity would require the charity to either wind up or dispose of its interest in the for-profit company within 7 years, and to make annual reports to the PGT before it is wound up.

As an alternative, other arrangements for shareholding may be considered. Examples would include having some or all of the directors or a few senior management staff of the charity to be shareholders of the for-profit company. Although this may avoid the restrictions imposed by the *Charitable Gifts Act*, other concerns would need to be addressed, such as exposure of the business to creditors of these individuals; the impact on the business in the event of a dispute between these individuals and the charity; and the impact of their ownership of the business on their personal tax position, etc. Although some of these issues may be addressed by putting in place a binding unanimous shareholders agreement, the viability of such an arrangement would depend on the degree of risk tolerance that the charity is willing to be exposed to. However, due to the broad interpretation by the courts and the PGT on the application of the *Charitable Gifts Act*, it is not entirely clear whether the restrictions of the *Charitable Gifts Act* would be avoided if the charity is seen to have retained an indirect interest in the business as a result of the charity having direct or indirect control or influence over the shareholders.

As a further alternative, it is possible to incorporate a new non-share capital non-profit corporation that would be a tax-exempt "non-profit organization" to hold the shares of the for-profit company. This option is reviewed below in section C3 of this paper.

The legislative progress of the *Charitable Gifts Act* would need to be closely monitored during the 7-year period, in the event that the 7-year requirement was to be revised or repealed by the provincial government. Furthermore, it would also be prudent to monitor any case law developments involving the restrictions imposed by the *Charitable Gifts Act* to determine if there were any cases that would shed light on the interpretation and application of this statute.

c) Foundation not controlling a corporation – Income Tax Act (Canada)

As explained above, charitable foundations (both public and private) cannot control a corporation, failing which the foundation could be subject to a monetary penalty or even revocation. If a foundation was involved in the business activity, care must be taken in structuring the shareholdings of the for-profit company to ensure that the foundation would not be negatively impacted. A foundation's charitable status would not be revoked as long as it does not acquire more than 5% of the shares of a for-profit company. To avoid revocation, it is possible to have an individual incorporate the company and gift the shares to the foundation, so that the foundation would not acquire more than 5% of the shares for consideration. However, if the foundation is gifted such number of shares so that it holds more than 50% of the shares of the for-profit company with full voting rights, then the foundation would still be subject to a monetary penalty ranging from 5% to 100% of the tax on dividends paid to the foundation, although the foundation would not be subject to revocation. In order to avoid the penalty tax, the foundation should not hold more than 50% of the shares of the for-profit company

d) Governance and liability issues

In order to implement this option, it would be necessary for the charity to consider governance issues involving the for-profit company. For example, the charity would need to consider who would act as directors and shareholders of the for-profit company. In addition, the charity would also need to give consideration to the relationship between the charity and the for-profit company. Other clauses may be included in the by-laws of the for-profit company to address other issues, such as provisions to ensure that the for-profit company would donate its profits to the charity, etc.

In addition, the close relationship between the charity and the for-profit company may possibly increase the exposure of the two entities to crossover liability. It is important that appropriate relational mechanisms be put in place for the for-profit company in order that the charity can ensure that the future direction and operations of the for-profit company will remain under the supervision of the charity. However, the closer the relationship between the two entities, the greater the possibility would be of exposure to crossover liability between them.

2. <u>Non-Profit Organization</u>

Another option would be to incorporate a non-share capital corporation that would be a tax-exempt "non-profit organization" ("NPO") under paragraph 149(1)(l) of the ITA[122] but would not be a registered charity. However, the application of this option of utilizing an NPO as an intermediary entity may be limited, since NPOs are generally not permitted to carry on business to earn a profit. An NPO must be organized and operated exclusively for social welfare, civic improvement, pleasure, recreation or any other non-profit purposes. The criteria that would be reviewed in

[122] In order to qualify as an NPO, there are four criteria under paragraph 149(1)(l) of the ITA that the corporation must satisfy. These criteria are explained in detail in paragraph 1 of CRA's *Interpretation Bulletin* IT-496R, "Non-Profit Organizations", August 2, 2001. For a more detailed review of these criteria, see section D2 below.

determining whether it is operated for non-profit purposes include whether the association is carrying on a trade or business; and whether the association has accumulated excess funds each year that are beyond the association's reasonable needs to carry on its non-profit activities. As such, if an NPO was to operate a for-profit business activity, it is doubtful that its NPO status would not be jeopardized.

However, the utilization of an NPO as an intermediary may be appropriate in some circumstances, e.g. by holding title to an income generating real property. In that situation, income earned by the NPO would be donated to the charity. This option would allow the charity to avoid application of the 3-year limitation period imposed by the *Charities Accounting Act* and allow the real property to be held for a longer period of time, even if it is not occupied or used by the charity for its charitable purposes. Since the NPO is a tax-exempt entity, it would avoid having to pay tax on income derived from the rental and eventual sale of the property. However, even if this option is possible, there are still a number of concerns. For example, in light of the broad application of the *Charitable Gifts Act*, and if the charity continues to have an indirect interest in the NPO (e.g. by means of controlling the board of directors of the NPO, or entering into a contract with the NPO to require the NPO to pay its income to the charity, etc.), it is not entirely clear whether the limit imposed by the *Charitable Gifts Act* would still apply to the interest held by the NPO. Furthermore, there are also governance issues, similar to those involved in the for-profit company option, that would need to be addressed. Since an NPO cannot pay its income to its members, consideration would need to be given to who the members and directors of the NPO would be. In addition, the charity would also need to give consideration to the relationship between the charity and the non-share capital corporation, without increasing the possibility of exposure to crossover liability between them.

Whether an NPO would be a viable option in the event that an organization was to forego charitable status and operate as a tax-exempt NPO is reviewed in the next section of this paper.

3. <u>Combination of For-Profit Company and Non-Profit Corporation</u>

As a variation of the two options above, it may be possible to utilize a combination of a for-profit company and a non-share capital corporation. In this regard, a for-profit company would be incorporated to operate the business activity, and 100% of the shares of the for-profit company would be owned by a newly incorporated tax-exempt non-share capital corporation which would be an NPO. A possible advantage of this option is that by having the NPO owning all of the shares of the for-profit company, it would be intended that the limitations imposed by the *Charitable Gifts Act* on holding a 10% interest of a business may be overcome. Again, if the charity somehow has an indirect interest in the NPO, and given the broad interpretation of the application of the *Charitable Gifts Act*, it is not clear that the non-application of the *Charitable Gifts Act* is without doubt.

In order for this option to be viable, it would be necessary to ensure that ownership of 100% of the shares of the for-profit company would not jeopardize the NPO status of the non-share capital corporation. CRA's Technical Interpretation 2002-0153887 dated August 19, 2002 explained that not only can an NPO carry on income-generating activity (provided that there is a causal relationship between the profit making activity and the exempt purpose of the organization), but an NPO may also derive income from a taxable subsidiary.[123] In a CRA document in 2001,[124] CRA indicated that if an organization holds all the shares of the capital stock of a taxable corporation, its NPO status is not necessarily endangered. However, CRA indicated that it would issue an advance ruling that an NPO holding shares of a subsidiary will not be subject to paragraph 149(1)(l) of the ITA, based on an assumption that the profits stemming from the said shares will be used exclusively for the NPO's non-profit activities. Accordingly, it does not appear that the ownership by an NPO of shares of a taxable wholly-owned subsidiary would necessarily affect the NPO status of the parent NPO, provided that the NPO continues to satisfy all requirements under paragraph 149(1)(l) of the ITA.

Therefore, for the purpose of maintaining the NPO status, it would not be problematic for a non-share capital corporation to hold shares of a wholly-owned for-profit corporation, provided

[123] Specifically, CRA states as follows:

> Our understanding of the jurisprudence is that corporations may derive income from a taxable subsidiary, if the deriving of that income is ancillary to its non-profit objectives and the income [is] expended wholly in accordance with those objectives. However, where a corporation's sole objective is to fund specified activities and not carry on such activities directly we believe the better view is that it is a for-profit entity. It is also our view that an organization may directly engage only in funding activities; however it can carry out other activities that are in furtherance of its other objectives indirectly through a wholly-owned subsidiary.
>
> Where an organization that otherwise qualifies as a non-profit organization proposes to engage in an unrelated profit making enterprise, it is our view that, if the organization were to carry out this unrelated activity in a taxable, wholly-owned corporation and this corporation were to pay dividends out of its after-tax profits to the organization to enable the organization to carry out its non-profit activities, the organization may qualify as a non-profit organization as set out in paragraph 149(1)(l) of the Act.

[124] CRA, document number 2001-0093245, October 5, 2001.

that the non-share capital corporation continues to satisfy the requirements of being an NPO. Since the non-share capital corporation would not have any activities other than holding the shares of the for-profit company, this may be a negative factor that may jeopardize its NPO status.

4. Business Trust

A further option would involve the use of a business trust as an intermediary. In this regard, the trust would operate the business activity. The charity would become an income beneficiary of the trust and income earned by the trust would be distributed to the charity as an income beneficiary.

Although trusts are subject to tax (at the top marginal rate, without personal deductions or credits), one of the benefits of this option is that income that is distributed by the trust to the charity as an income beneficiary would not be subject to tax. Usually, when pre-tax income of a trust is distributed to its beneficiary, the income would be taxed in the hands of the beneficiary and not taxed at the trust level. Since the charity is a tax-exempt registered charity, income it receives from the trust is exempt from income tax.[125] Excess funds paid to the charity could be shifted back to the trust by way of arrangements such as a loan or other payments (but not gifts, since registered charities cannot make gifts to a business trust). Another benefit of using a trust is the ability to distribute pre-tax profits to beneficiaries, regardless of whether they are taxable or non-taxable entities. Therefore, a trust arrangement can be used to bring in other parties to participate in a business venture.

However, it is not entirely clear whether this option would avoid the application of the *Charitable Gifts Act* due to its broad interpretation and application. In this regard, if the charity holds a beneficial interest in the trust and if the trust operates the business, it is not entirely clear whether the PGT would still recognize the charity, as a beneficiary of the trust, as having an interest in the business through the trust and therefore be caught by the application of the *Charitable Gifts Act*. As an alternative, it may be possible to utilize a combination of a business trust and a for-profit company. In this regard, the for-profit company would operate the business, with the business trust holding 100% of the shares of the for-profit company, and with the charity being the income beneficiary of the trust. However, for the same reasons set out above, it is also not clear whether

[125] Subsection 104(6) of the ITA.

this more remote option of holding the interest in the business would be an effective way of avoiding the application of the *Charitable Gifts Act*.

The utilization of the business trust has a number of concerns that a charity would need to give consideration to when determining whether the use of a trust is a viable option. One of the disadvantages of utilizing a trust is that the ITA provides that a trust is deemed to have disposed of and immediately reacquired its capital property and land inventory every 21 years for fair market value proceeds.[126] This rule is intended to ensure that trusts cannot be used to indefinitely defer taxation of accrued gains in respect of such assets. As a result, the trust will need to pay income tax every 21 years. Another concern is that a trust is subject to the rule against perpetuities. While a corporation can exist in perpetuity, a trust cannot. At common law, an interest that could potentially vest outside the perpetuity period (e.g. 21 years in Ontario) would be invalid.[127] Perpetuities legislation varies from province to province. For example, in Ontario, the *Perpetuities Act* (Ontario)[128] modified the rule, and now instead of asking what could conceivably happen, we "wait and see" whether the interest does in fact vest within the period. Thus, a contingent interest in Ontario is only invalid if it must or actually does vest outside the perpetuity period. However, if the charity is prepared to have the trust dispose of the property in the trust in a shorter period of time, then there would not be any concern with offending the rule against perpetuities. Another issue to be aware of is that the business trust would be subject to applicable provincial trustee legislation. Therefore, the drafting of the trust deed will need to take into consideration the applicable trustee legislation.

Appropriate relational mechanisms will need to be put in place in order that the charity can ensure that the future direction and operations of the trust will remain under the supervision of the charity, and that profits would be paid to the charity or be used for its benefit. However, the closer relationship between the two, the greater would be the possibility of exposure of the two entities to crossover liability. In addition, careful consideration would need to be given in relation to who would become trustee(s) of the trust and how those trustees may be replaced. One option is for

[126] Subsection 104(4) of the ITA.
[127] A review of the rule against perpetuities is outside the scope of this paper. For an overview of the application of the rule against perpetuities on charities, see article by Adam Parachin, "Charities and the Rule against Perpetuities" (2008) vol. 21, no. 3 *The Philanthropist* 256.
[128] R.S.O. 1990, c. P.9.

certain directors of the charity to be the trustees. Another possible option could involve the incorporation of a new non-share capital non-profit corporation to be a corporate trustee, where the directors of the charity would also be directors of the non-profit corporation. Another concern with the utilization of a trust is that trustees of the trust would be personally liable for the actions of the trust. One way to mitigate this factor is for trustees to be indemnified for personal liability arising from their acts or omissions in performing their duties and the purchase of a directors/officers insurance policy. In that scenario, it is important to ensure that the indemnity and/or directors/officers insurance policy are permitted under provincial statutes, such as the *Charities Accounting Act* (Ontario) and its regulations.

D. CARRYING ON BUSINESS ACTIVITIES THROUGH OTHER FORMS OF ENTITIES BY FOREGOING CHARITABLE STATUS – GETTING OUTSIDE THE BOX!

The previous section of the paper shows that the use of parallel intermediary entities to operate business activities is not without concerns. Regardless of the type of intermediary utilized, e.g. for-profit company, business trust, etc., each option has its own pros and cons, as well as additional issues to address and limitations on how the business activities may be operated. While some may find it possible to operate within these confines, some may find that the limitations of such arrangements far outweigh the benefits.

As such, a more drastic approach would be to forgo charitable status and operate completely through other vehicles. Examples would include operating through for-profit companies, partnerships, etc. As well, the utilization of tax-exempt entities may be appropriate under some circumstances. Entities listed in subsection 149(1) of the ITA are exempt from paying taxes under Part I of the ITA. Examples of these tax-exempt entities include municipalities, corporations owned by the Crown, agricultural organizations, boards of trade, chambers of commerce, low-cost housing corporations for the aged, non-profit corporations for scientific research and experimental development, labour organizations, non-profit organizations (NPOs), pension trusts and corporations, etc. The laws that apply to each of these entities vary.

One of the main benefits of this approach is freedom in operating the business activities from the restrictive requirements imposed on charities. However, where a taxable entity is utilized, consideration would need to be given to ensure that the tax payable would not be a deterring factor.

Another possible disadvantage of this option is that these entities would not have the ability to raise funds through public donations (since these entities cannot issue donation tax receipts for donations received). A further potential disadvantage of this approach is that these entities, especially taxable for-profit companies, may not be eligible for government or other public funding.

While it is not possible to review the use of all these entities, the balance of this section reviews the use of two options that are more commonly considered, namely the use of taxable for-profit companies and tax-exempt NPOs.

1. For-Profit Company

One option is to incorporate a for-profit business share capital corporation. This corporation would operate all activities, including both business activities and charitable programs. The for-profit company is a taxable entity and would have to pay tax on its taxable income. Therefore, one of the key drawbacks that would need to be accepted is the payment of tax. Since there is only one entity, all charitable endeavours, if any, would be conducted through the for-profit company.

Some of the more common ways to achieve the corporation's charitable objectives would be through third party charities, such as making gifts to charities and sponsoring events and/or programs of charities.[129] Similar to using a for-profit company as an intermediary, the pre-tax profits of the stand-alone for-profit company may be donated to charities, thereby reducing the tax liability of the for-profit company. As explained above, a corporation may deduct the eligible amount of gifts made to qualified donees in the year or in the preceding 5 years.[130] In general, as discussed above, the for-profit company is entitled to a tax deduction from its taxable income, up to a maximum of 75% of its net income. If the for-profit company donates a gift of appreciated capital property to a charity, the limit is increased by 25% of the taxable capital gain and 25% of any recapture of capital cost allowance realized on a gift of depreciable capital property (but only up to 25% of the lesser of the capital cost or the fair market value of the depreciable property).

[129] For an overview of the tax implications of corporate giving and how corporations may support charities, see paper by Theresa L.M. Man, "Corporate Giving: A Tax Perspective" September 18, 2006 (online: http://www.charitylaw.ca/articles.html) and Carole Chouinard, "Considerations in Corporate Giving," (2008) vol. 21, no. 4 *The Philanthropist* 297.
[130] *Supra* note 121.

Similarly, other types of gifts may also be given to charities, such as in-kind gifts and gift certificates.[131]

Where sponsorships are provided to charities (e.g. naming rights and use of the corporate name in charitable events), the deduction of sponsorship fees may be deducted as business expenses under section 18 of the ITA, provided that the deduction is made in respect of an outlay or expense that was reasonable in the circumstance. In this regard, the marketing, advertising or promotion expenses to be deducted by a business under section 18 of the ITA must meet six tests, namely that it must be of an income nature and not a capital expenditure, be reasonable in amount, be incurred for the purpose of earning income, not be a personal expenditure, not be expressly prohibited by the Act, and not constitute "abusive tax avoidance."[132] Section 67 of the ITA provides that in computing the income of a business, only expenses reasonable in the circumstances can be deducted.[133] What is reasonable is a question of fact, and may be decided by comparing the expense in question with amounts paid in similar circumstances by comparable businesses.[134]

Therefore, the business will need to review the marketing, advertising, and promotion expenses in question and determine whether the business would be paying the same amount for similar marketing, advertising, and promotion arrangements in the market. For example, if the business received recognition as a donor in the charity's widely-distributed monthly newsletters in appreciation of a contribution made by the business, then the business may need to determine what a similar advertisement in a publication with similar circulation would cost. It might be difficult to find appropriate comparable scenarios, especially when some benefits associated with the contribution may not be quantifiable and may not available if the business were to place an advertisement itself in the commercial market. For example, the business's public image might be increased by being associated with having made a donation to the charity and being publicized to the public, and therefore it might justify the business's willingness to pay more to the charity to obtain that exposure rather than to pay for an advertisement in a publication itself.

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[131] For a review of the tax treatment of these gifts, see paper by Theresa Man *supra* note 26.
[132] Krishna, *supra* note 31 at 322 and see *Royal Trust Co. v. M.N.R.* (1956) C.T.C. 32 at 42, 57 D.T.C. 1055 (Ex. Ct.)
[133] The courts have held that the governing principle for applying section 67 is that "it is not a question of the Minister or this Court substituting its judgment for what is a reasonable amount to pay, but rather … coming to the conclusion that no reasonable business man would have contracted to pay such an amount." See *Gabco Ltd.*, [1968] C.T.C. 313 (Ex. Ct.), approved in *Petro-Canada*, [2004] 3 C.T.C. 156 (F.C.A.) (leave to appeal denied 2004 CarswellNat 4108 (S.C.C.)).
[134] Krishna, *supra* note 31 at 334.

In relation to the "purpose test" for the ability of the business to deduct sponsorship fees as a marketing, advertising or promotion expense, the fees must be incurred for the purpose of earning income. There is no requirement that income must be earned after having incurred the expenditure.[135] For example, "if a taxpayer incurs advertising expenses for the purpose of promoting sales, failure of the advertising program to stimulate sales doe not disqualify the expenditure as a deductible expense."[136]

Where a for-profit company operates charitable programs itself, it is not entirely clear whether expenses on these programs could be deductible under section 67 of the ITA, since these are not expenses incurred for the purpose of earning income. This may be one of the reasons that for-profit companies may not find it attractive to operate charitable programs directly.

Other ways that a for-profit company may indirectly conduct or achieve charitable objectives would include providing services or resources for charities, such as the loan of a piece of property to a charity for the charity's free use, such as the use of a piece of equipment, the use of the company's premises for activities of the charity, or the use of a cottage for a week as a prize in a fundraising auction event. However, the provision of free use of property is not a gift.[137] The corporation would not be entitled to a donation receipt for the rent that the corporation has foregone by loaning it to the charity for free or for the value of the property loaned. In this regard, CRA takes the view that the term "transfer" has to involve more than merely granting a right to use property for a limited time.[138] However, it is possible for a charity to pay rent on a property to the corporation and the corporation subsequently donate to the charity all or part of the rent payment paid, as long as the gift from the corporation is voluntary. The charity may then issue a donation receipt for the gift received. The corporation would have to report the income earned from the rental payment but would be able to claim the tax deduction with the received donation receipt.

Because expenses incurred by a for-profit company to operate charitable programs itself may not be eligible for deduction as business expenses, a for-profit company may wish to establish a

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[135] Krishna, *supra* note 31 at 336.
[136] *Ibid*. See also *Royal Trust*, *supra* note 132.
[137] Similarly, loaning the use of time-share and recreational property are not considered as gifts under the ITA. See CRA, *Registered Charities Newsletter* No. 18, Spring 2004.
[138] CRA, *Information Letter* CIL-2002-009, July 10, 2002; and CRA, *Registered Charities Newsletter* No. 22, March 2005.

parallel corporate foundation to carry out its charitable giving program. In this sense, it has been noted that the following are some of the advantages of doing so:[139] better coordination of corporate giving programs; better public perception than a company's own donations program; elevated public image of the company being fiscally or corporately responsible within the community; separating donations from internal business pressures; and building an asset base for consistent long-term charitable giving even when corporate profits are down. In addition, having a corporate foundation would enable the for-profit company to make donations to its corporate foundation according to its business needs and planning and the for-profit company may collaborate with its corporate foundation so that its charitable program would complement the business goals of the company.[140] Depending on the specific goals that a particular social entrepreneur wants to achieve, to a certain extent, the use of a parallel corporate foundation may achieve some aspect of a social enterprise.

2. <u>Non-Profit Corporation</u>

Instead of operating through a for-profit company, in some situations, it may be appropriate to operate through a tax-exempt NPO under paragraph 149(1)(l) of the ITA. Both registered charities and NPOs are exempt from tax (except certain income of NPOs whose main purpose is to provide dining, recreational or sporting facilities for its members).[141] While registered charities may issue donation tax receipts to their donors, NPOs cannot.

One of the key elements of the viability of utilizing an NPO is that the corporation must satisfy four requirements to be considered an NPO as set out in paragraph 149(1)(l) of the ITA. These criteria are explained in detail in paragraph 1 of CRA's Interpretation Bulletin IT-496R[142] and summarized below:

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[139] Norah McClintock, "Laying a Foundation for Corporate Giving," *Front & Centre* (July 1994) Vol 1, No. 4, at 14; Michael Kray, "Establishing a Private Foundation." *The Advisor* (Spring 2006). The rationale and factors for considering when establishing a private foundation for individuals are not the same as those for the establishment of corporate foundations by businesses. For the former, see Hoffstein, *supra* note 96; Wolfe D. Goodman and Howard Carr, *Establishing a Private Foundation* (Toronto: Canadian Centre for Philanthropy, 1987).
[140] Norah McClintock, "New-Style Corporate Foundations," *Front & Centre* (May 1997) Vol. 4, No. 3 at 3.
[141] Subsection 149(5) of the ITA.
[142] CRA, *Interpretation Bulletin* IT-496R, "Non-Profit Organizations", August 2, 2001.

(a) It is not a charity;
(b) It is organized exclusively for social welfare, civic improvement, pleasure, recreation or any other purpose except profit;
(c) It is in fact operated exclusively for the same purpose for which it was organized or for any of the other purposes mentioned in (b); and
(d) It does not distribute or otherwise make available for the personal benefit of a member any of its income unless the member is an association which has as its primary purpose and function the promotion of amateur athletics in Canada.

Whether a particular association meets all of these criteria is a question of fact that can only be determined after reviewing the purposes and activities of the association.[143] It is essential that all these elements are met; otherwise, the corporation may lose its NPO status and become a taxable entity. It is important to note that there is no registration or approval mechanism for achieving NPO status. It is a status that an entity claims on a year-to-year basis in its income tax returns. Therefore, entities claiming NPO status must carefully monitor its operations on an on-going basis. In the event that CRA was to reject the claim for NPO status by an entity because not all of the criteria set out in paragraph 149(1)(l) of the ITA were satisfied, the entity would lose its NPO status as of the time of the contravention and become a taxable entity as of that date.[144] In this regard, the corporation would be deemed to have disposed of all its property at fair market value at the time immediately before the exempt status is lost, and to have re-acquired all property at fair market value at that time, resulting in capital gains tax on the deemed disposition.

Not only would an NPO have to meet all of the requirements under paragraph 149(1)(l) ITA, but it must also meet all requirements for non-profit organizations under provincial income tax statutes. Therefore, if an entity was to lose NPO status under the federal ITA, it would likely also lose its non-profit organization status under provincial tax legislation and other consequences may follow under the provincial statute. For example, in Ontario, subsection 57(2) of the *Corporations Tax Act* (Ontario)[145] provides for very serious consequences if the organization in question contravenes the requirements for an NPO, as set out in paragraph 57(1)(b) of the *Corporations Tax Act*. Similar to paragraph 149(1)(l) of the ITA, subsection 57(2)(a) of the *Corporations Tax Act* provides that if any part of the income of the organization is distributed to the members or shareholders of the organization, or if any of its funds or property have been appropriated for the benefit of the members or shareholders of the organization, then the organization would become taxable in

[143] *Ibid*. at paragraph 1.
[144] Subsection 149(10) of the ITA.
[145] R.S.O. 1990, c. C.40.

respect of its income for the year in which it loses its NPO status, as well as for all future income. The distinction between paragraph 149(1)(l) of the ITA and subsection 57(2)(a) of the *Corporations Tax Act*, which causes the latter to be more serious is that the latter also provides that all income from all previous years for which the organization qualified as an NPO would also be deemed to be income in the current taxation year. The NPO would also be subject to tax in the year in which it loses its NPO status and hence prior year income becomes currently and retroactively taxable.

In relation to the requirement that an NPO must not be a charity, there are two aspects to being a "charity" in this context. The first aspect is that the corporation is not a registered charity. This requirement can be easily met by not applying for charitable status. The second aspect is that an NPO also must not be a charity at common law. Being a charity at common law means an organization that is established under one or more of the four heads of recognized charitable purposes at common law, namely relief of poverty, advancement of religion, advancement of education, or purposes that benefit the community as a whole. This means that the objects of an NPO must not be exclusively for charitable purposes. As such, the corporate objects of the NPO would be carefully drafted to ensure that it would not be recognized as a charity in common law. The usual technique to achieve that is to include a non-charitable object in the objects of the NPO to act as a "poison pill", such as an object to influence elected representative or public government officials to retain, oppose or change public policy legislation or decisions of the government on certain issues.

In relation to the requirement that an NPO must be organized for non-profit purposes, the instruments creating the association will normally be reviewed and that these instruments may include letters patent, articles of incorporation, memoranda of agreement, by-laws, etc.[146] In this regard, it is possible to include a provision in the letters patent of the NPO stating that the corporation is to carry on its operations without pecuniary gain to its members and any profits or other accretions to the corporation are to be used in promoting its objects.

In relation to determining whether an entity was operated exclusively for, and in accordance with, its non-profit purposes in a particular taxation year is a question of fact on a case-by-case basis.

[146] *Supra* note 142 at paragraph 5.

This information can be obtained only by reviewing all of an entity's activities for that year. One of the criteria that would be reviewed is whether the association is carrying on a trade or business. CRA takes the position that "carrying on a trade or business directly attributable to, or connected with, pursuing the non-profit goals and activities of an association will not cause it to be considered to be operated for profit purposes."[147] Our review of the various cases and CRA documents indicates that the following are indicia that an activity is not carrying on a trade or business:

- there must be a causal relationship between the profit-making activity and the exempt purposes;[148]

- the income generating activity must be carried on, and the resulting income must be used by, the corporation in carrying out its exempt objectives;[149]

- the income generating activity must be directly attributable to, or connected with, pursuing the non-profit goals and activities of the organization;[150]

- the income generating activity can only be an incident of its purposes, but not the principal activity of the corporation;[151] and

- the earning of income must not be an operating motivation and it must not be the focus of the activity of the organization (e.g. where the activities have been undertaken; if more than 50% of assets, revenue, time, attention and efforts have been expended; taking into account various factors, including the purpose for which the business was originally commenced, the history and evolution of its operations, and the manner in which the business is conducted;[152] or where the activity is merely earning passive investment income[153]).

[147] *Supra* note 142 at paragraph 7.
[148] Technical Interpretation 2002-0153887 dated August 19, 2002.
[149] CRA, document number 9704605 dated February 17, 1998; *Gull Bay Development Corporation v. Her Majesty the Queen* . 84 D.T.C. 6040 (F.C.T.D.).
[150] *Supra* note 142 at paragraph 7.
[151] *L.I.U.N.A. Local 527 Members' Training Trust Fund* v. *The Queen*, [1992] 2 CTC 2410, 92 D.T.C. 2365.
[152] CRA, document number 2004-0060451E5, dated April 1, 2004, and CRA, *Interpretation Bulletin* IT-73R6 on "The Small Business Deduction"; *Tourbec (1979) Inc. v. M.N.R* 88 D.T.C. 1442; CRA, document number 2002-0119895 dated May 13, 2002; *L.I.U.N.A. Local 527 Members' Training Trust Fund* v. *The Queen*, [1992] 2 C.T.C. 2410, 92 D.T.C. 2365.

Whether the above criteria could be met and therefore would not jeopardize the NPO status of the corporation is a question of fact that would need to be assessed on an on-going basis. However, if the NPO was to operate a business to earn profits, it is doubtful that these criteria can be met. Nevertheless, the utilization of an NPO may be appropriate in some circumstances (e.g. by holding title to an income generating real property without other active business activities). Considerations in this regard are set out in section C2 above.

Another criterion when determining if an association is operated exclusively for non-profit purposes is whether the association has accumulated excess funds each year that is beyond the association's reasonable needs to carry on its non-profit activities. In this regard, paragraphs 8 and 9 of IT-496R provide as follows:

> An association may earn income in excess of its expenditures provided the requirements of the Act are met. *The excess may result from the activity for which it was organized or from some other activity*. However, if a *material part of the excess is accumulated each year* and the balance of accumulated excess at any time is greater than the association's *reasonable needs* to carry on its non-profit activities, *profit will be considered to be one of the purposes for which the association was operated*. ….
>
> The amount of accumulated excess income considered reasonable in relation to the needs of an association to carry on its non-profit activities and goals *is a question of fact to be determined with regard to the associations' particular circumstances, including such things as future anticipated expenditures and the amount and pattern of receipts from various sources (e.g., fund raising, membership fees, training course fees). … Where the present balance of accumulated excess is considered excessive or an annual excess is regularly accumulated that is greater than an association's needs to carry on its non-profit activities, it may indicate that the association's aims are two-fold: to earn profits and to carry out its non-profit purposes.* In such a case, the operated exclusively requirement in paragraph 149(1)(l) would not be met. [Emphasis added]

Therefore, care must be taken to monitor the income that the corporation retains. Furthermore, it is important to ensure that income would not be accumulated to a level that may take the corporation off-side the requirements to be an NPO.

The fourth criterion to qualify as an NPO requires that no part of its income be made available to the members or shareholders of an NPO. In this respect, an association may fail to comply with this

[153] *Ibid*.

requirement in a variety of ways, e.g. if it distributed income during the year, either directly or indirectly, to, or for the personal benefit of any member, or if it has the power at any time to declare and pay dividends out of income.[154] Certain types of payments made directly to members, or indirectly for their benefit, will not, in and of themselves, disqualify an association from being an NPO.[155] Examples of such reasonable payments include: salaries, wages, fees or honoraria for services rendered to the association. Another example would be payments made to employees or members of the association to assist them in covering their expenses to attend various conventions and meetings as delegates on behalf of the association, provided attendance at such conventions and meetings is to further the aims and objectives of the association.[156] Upon dissolution of an NPO, care must also be taken that no income would be paid to its members.[157]

In summary, the above review indicates that the viability of using an NPO in lieu of charitable status is not high. Only in limited circumstances and through very careful planning would this option be viable.

E. CARRYING ON SOCIAL ENTERPRISE BUSINESS ACTIVITIES OUTSIDE OF THE CHARITIES REGULATORY REGIME - JUMPING FROM THE BOX INTO A TREASURE CHEST?

The review above indicates that the current Canadian regulatory regime for registered charities is very restrictive of their ability to engage in business activities, let alone social enterprise activities. In order to overcome some of the restrictions imposed on registered charities, charities have to utilize alternative structures and arrangements to operate business activities, which may be complex in implementation and are not always ideal in achieving their goals.

In general, there are a number of goals that social enterprises wish to achieve, which the Canadian regulatory regime for registered charities cannot meet. One of the key reasons for this is the need to find new ways to raise capital and/or income stream for carrying on charitable endeavours. Examples would include raising capital by issuing shares, paying dividends, paying a return on investments, etc., which registered charities cannot do. Another reason is to have the ability to pay founding directors of a social enterprise who would have a legitimate reason to remain in control

[154] *Supra* note 142 at paragraph 11.
[155] *Supra* note 142 at paragraph 12.
[156] *Ibid*.
[157] *Supra* note 142 at paragraph 11.

of it. At common law, directors of charities are not permitted to receive any direct or indirect remuneration.[158] A further reason is that governments may wish to mobilize private capital to help struggling businesses or communities.[159] Another possible reason is to have a vehicle to allow charities to effectively enter into joint venture social projects with for-profit entities and the public sector. Apart from the above factors, there may be other reasons that may support organizations to operate in a new framework outside of being a charity. For example, registered charities in Canada are prohibited from engaging in political activities, failing which they may lose their charitable status.[160]

At this time, as The Right Honourable Paul Martin correctly pointed out, what is needed in Canada is a "hybrid with which the policy makers have not yet caught up."[161] In this regard, it is necessary to learn from what the United States and the United Kingdom have done to encourage the development of social enterprise. In addition, in coming up with a Canadian solution, it is necessary to develop a coordinated approach. Therefore, the development of such a solution would require much thorough research and consultation. The authors do not intend to propose a solution in this paper; rather, features that may be considered in developing a solution are suggested. Such features could include: implementing a suitable corporate vehicle; providing attractive tax incentives for investors; ensuring the assets and resources of a social enterprise are used primary for social return rather than a profit return; addressing securities legislation issues if the new vehicle is permitted to raise capital by issuing shares; allowing charities to "invest" in social enterprise entities with their "investments" being counted towards meeting their disbursement quota; addressing the application of provincial investment legislation; the possibility of providing full or partial tax-exemption status for social enterprises; as well as providing statutory authority to pay remuneration for directors, etc.

For example, some have suggested that the alternative structures and arrangements that charities currently use to operate business activities (e.g. the use of for-profit companies, business trusts, etc.) are "schemes, loopholes, and behaviours", while meeting the needs of the charitable sector from an

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[158] *Supra* note 118.
[159] Mannweiler Foundation Inc., *supra* note 20.
[160] Subsection 149.1(6.1) and (6.2) of the ITA.
[161] *Supra* note 1at 237.

ownership or taxation perspective, do not "meet governance requirements"[162] and therefore the need for a new business vehicle "Company for Social Enterprise" has been proposed.[163] Although the authors do not agree that those arrangements are "schemes [and] loopholes" because they are legitimate corporate and tax planning vehicles, it is true that a new vehicle is required. Lessons can be learned from the CICs for examples of the types of feature that a new Canadian vehicle may have. In addition, if the new vehicle is permitted to raise funds through issuing shares, it is suggested that the legislation explicitly address issues involving shareholders with whom the corporation may lose contact over time, which is not a minor a problem that many public share-capital social clubs incorporated under the *Corporations Act* (Ontario) before the 1970s currently face.[164] Depending on what features would be attached to such a new vehicle, another approach is to allow entities to be incorporated under existing general corporate statutes, such as the *Canada Corporations Act*, and provide other attractive features through alternative means, such as providing full or partial tax-exemption status to these entities.

Other than changes to corporate statutes, amendments to the ITA would also be required in order to provide attractive tax incentives to investors of social enterprise, and possibly also to allow registered charities to "invest" in social enterprise entities with their "investments" being counted towards meeting their disbursement quota requirements. In this regard, the Right Honourable Paul Martin's address at the Munk Centre for International Studies on November 8, 2007 pointed out that financial liquidity is available for social enterprise that is not necessarily seeking the highest return possible, but is intending to target social good, if the right tax incentives are provided. Such tax incentives would enable social entrepreneurs to tap capital markets the same way their business counterparts can.[165] After reviewing steps that the United States has taken in relation to L3Cs and those of the United Kingdom's in relation to CICs, he suggested that possible tax incentives can be given along the same lines as the tax incentives that are currently provided to labour-sponsored funds, the Canadian film and video production tax credit program, and flow-through shares that

[162] Sid Gould, "Social Enterprise and Business Structures in Canada: a Discussion", Fraser Valley Centre for Social Enterprise, February 2006 (online: www.fvcse.stirsite.com/f/SEandBusinessStructures.doc).
[163] *Ibid*.
[164] For a review of Ontario public share-capital social clubs, see paper by Theresa L.M. Man and Terrance S. Carter, "Share Capital Social Clubs as NPOS: Issues to Consider" paper presented at the Ontario Bar Association Seminar on *Legal Issues of Charitable and Not-for-Profit Organizations*. October 27, 2004 (online: http://www.carters.ca/pub/article/charity/2004/tlmtsc1027.pdf).
[165] *Supra* note 1 at 238.

encourages investment in resource-based exploration.[166] In addition, other federal and provincial legislative changes may also need to be coordinated, such as provincial investment statutes, securities statutes, as well as the *Charitable Gifts Act* and *Charities Accounting Act* in Ontario.

It is clear that Canada is behind many countries in providing a favourable environment for the development of social enterprise. In this regard, it is hoped that the Canadian government would take up the challenges in the near future because, in the words of Mr. Paul Martin, "we are at a point in our nation's history where we can do this. All the elements are there."[167]

[166] *Supra* note 1 at 239.
[167] *Supra* note 1 at 240.