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CHARITY LAW BULLETIN NO. 200

Carters Professional Corporation / Société professionnelle Carters
Barristers, Solicitors & Trade-mark Agents / Avocats et agents de marques de commerce

MARCH 30, 2010
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BUSINESS ACTIVITIES – RAISING REVENUE THROUGH BUSINESS ACTIVITIES WITHOUT VIOLATING LEGAL PRINCIPLES: PART 2

By Donald J. Bourgeois *

The issue of raising revenue using business activities is one that deserves attention by the board of directors and senior management of any organization that is considering it. In Charity Law Bulletin No. 196, the issue was introduced and discussed as it relates to charitable organizations. In this column, we discuss Canada Revenue Agency's guidance with respect to business activities. The final column will review the issue from the perspective of a not-for-profit organization that is not a charity.

The underlying policy considerations are likely not surprising. First, a registered charity is intended to carry out charitable activities. That fundamental purpose is why it benefits from both an exemption from income taxation and the authority to issue receipts for income tax purposes. The issuance of receipts for a donation allows the donor to obtain a credit or deduction on his, her or its income tax return. Second, business is a risk. While all activities in life have a degree of risk, businesses are intended to put at risk the assets with a view to obtaining a return on those assets – generally, a return that is commiserate with the level of risk. Third, a charity that competes with a business in the marketplace is considered to have an unfair advantage.

Canada Revenue Agency (CRA) has articulated the underlying policy in a number of documents, including Summary Policy CSP-B02 (Revised June 14, 2007). This policy summary notes that a charitable organization or a public foundation (but not a private foundation) may carry on *related businesses that accomplish or promote their charitable objects*.

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This concept of "related business" – one that is intended really to advance the charitable purposes of the organization – is critical to understand. A related business, according to CSP-R05 (October 25, 2002) is a commercial activity (i.e., revenue generating) that is either related to the charity's purposes or is substantially run by volunteers. CRA considers 90 per cent to be "substantial" for this purpose. Thus, a bingo event that is used to raise money is a related business if it is substantially run by volunteers.

Parliament has defined "related business" in section 149.1 of the *Income Tax Act*, which guides CRA in its application of the concept. It is defined as follows:

> "related business", in relation to a charity, includes a business that is unrelated to the objects of the charity if substantially all persons employed by the charity in the carrying on of that business are not remunerated for that employment.

Typical of income tax legislation, the approach is a somewhat negative one but the essential point is captured in the wording. Perhaps more importantly, subsections 149.1(2) and (3) authorize the Minister to revoke the registration of a charitable organization or a public foundation that carries on a business that is not a related business of that charity. A private foundation may not carry on a business, whether related or not.

CRA has identified several criteria in CSP-019 (March 31, 2003) to assess whether or not a particular activity of a charity is a business. These include:

- the intended course of action, i.e., is the rationale to generate a profit;
- the potential to show a profit, i.e., intention and capacity to make a profit at some point;
- the existence of profits in the past; and
- the expertise and experience of the person or organization that undertakes the activity, i.e., has the individual been selected for the position because he or she has commercial knowledge, skill or experience.

These criteria are all factual in nature. Whether an activity falls within the exemption or outside the exemption will be answered by evidence. A number of activities would not appear to be a problem:

- the business activities are usual and necessary concomitant of the charitable programs, such as a parking lot or cafeteria at a hospital;

- an off-shoot of a charitable program in which an asset can be exploited in a business, such as a heritage village that processes its crops for sale to visitors who watch, for example, the milling of wheat into flour;
- use of excess capacity to gain income when the asset or staff is not being used to full capacity within the charitable program, such as rental of tents purchased for an arts festival during the remainder of the year, or a church that rents out its parking lot during the week when there is no church service;
- sale of items that promote the charity or its objects, such as cookies that display the charity's name or logo, or posters that depict the work of the charity;
- soliciting of donations, which is not really commercial in nature as the donor does not (and ought not) expect anything in return;
- selling of donated goods is not considered to be commercial, as a business would not depend upon donations to create inventories;
- fees charged in context of charitable programs provided the two essential characteristics of a charity are present – altruism and public benefit. Examples include tuition fees, rent in low-income housing, and museum admission fees. Some of the factors to be considered are if the fee is designed to defray costs rather than generate a profit, whether the program is otherwise available in the marketplace, and if the fee is set according to the charitable objective as opposed to market objective; and
- deriving income from investments, provided the investment is a prudent one and more passive in nature, i.e., managing the assets not required for current operations.

CRA will look to a number of factors in making its findings. What it wants to ensure is that the business activity is subordinate to the charity's purposes. The factors include:

- relative to the charity's operations as a whole, the business activity receives a minor portion of the charity's attention and resources;
- the business is integrated into the charity's operations, rather than acting as a self-contained unit;
- the organization's charitable objects continue to dominate its decision-making;
- 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.

What happens if a charitable organization or public foundation carries on business activities outside the exemption for "related business"? As noted above, the Minister has statutory authority to revoke the registration, subject to the processes set out in the *Income Tax Act*. This "nuclear bomb", though, is not likely the tool that a Minister would use for the less problematic and non-systematic situations. Instead, the Minister would use a graduated penalty approach.

The Minister has established a penalty approach involving monetary sanctions and suspensions. The first infraction by a charitable organization or public foundation would result in a five per cent penalty on the gross unrelated business revenue earned in a fiscal period. A similar penalty would be applied to a private foundation carrying any business. While at first blush this approach would not seem to recognize the distinction in the legislation between "public" and "private" foundation, but the sanction in the case of a public foundation is against its "unrelated business," not all of the business carried out. In any given fact situation, it may be possible for a "related business activity" to cross-over into an "unrelated business activity," it is this latter revenue that could be subject to the sanction in the case of a public foundation. However, all business revenue would be captured for a private foundation.

The repeat infraction is where, of course, a graduated penalty structure starts to hit harder. The sanction will be 100 per cent on gross unrelated business revenue earned in a fiscal period and suspension of tax-receipting privileges for a charitable organization and public foundation. For a private foundation, the penalty would be 100 per cent on gross business revenue and the suspension. While it could be argued that a suspension of tax-receipting privileges will result in the charity simply postponing receipting of the donation, it is not clear what would be the result if the charity artificially pushed receipting a donation to a later date. And, it is often not feasible to postpone a donation. Repeated infractions will also increase the probability of revocation.

The board of directors and senior management of a charity need to take care if the organization or public foundation is to carry out business activities. It is essential that the activities be – and be seen to be by CRA – as "related business activities". The failure of doing so can have substantial and negative effect on a charity. In the case of a private foundation, the directors and management need to ensure that no business activities occur, whatsoever.

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