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**THE OTTAWA REGION**  
**Charity & Not-for-Profit Law Seminar**

**Ottawa – February 2, 2012**

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**Maintaining NPO Status**

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*By Karen J. Cooper, LL.B., LL.L., TEP*

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**Maintaining NPO Status**

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**A. INTRODUCTION**

- The terms “non-profit” and “not-for-profit” (“NPOs”) are used interchangeably and generally refer to organizations whose profits are not passed on to their members
- Far-reaching influence on citizens’ well-being
  - Social, family and community service supports
  - Sports and recreation and arts and culture
  - Engagement in environmental, philanthropic, religious and other pursuits
- 161,000 charities and NPOs in Canada – CRA only keeps a record of the number of registered charities (about 82,000 in 2008)

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- Include voluntary recreational clubs (hence the difficulty in keeping track of their numbers), e.g., book clubs, chess clubs, cubs and scouts, sports clubs, etc.
- Other examples include service clubs, trade associations, professional associations, etc.
- Focus in this presentation is on NPOs (not registered charities)
- This presentation provides an update on recent CRA views on the tax exempt status of NPOs, including
  - Capacity of NPOs to earn profits
  - Carrying on a trade or business through an NPO
  - Tax consequences of losing NPO tax exemption

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**B. DIFFERENCES BETWEEN CHARITIES AND NON-PROFIT ORGANIZATIONS**

- See CRA website at <http://www.cra-arc.gc.ca/chrts-gvng/chrts/pplyng/rqstrtn/rqht-eng.html> for detailed comparison

1. Charities

- At common law a charity includes organizations established for one or more of the following recognized charitable purposes:
  - Relief of poverty
  - Advancement of education
  - Advancement of religion
  - Other purposes beneficial to the community recognized by the courts

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- Under the ITA – as one of the categories of “qualified donees”
  - Includes a “registered charity”
    - Not defined in the ITA, CRA uses the definition at common law
    - Charitable organizations, public foundations and private foundations
  - Also includes list of other entities, e.g., registered Canadian amateur athletic associations (RCAAA); municipal, provincial and federal governments; United Nations and its agents; prescribed universities

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- Advantages of being a charity
  - Does not pay tax on income or capital gains
  - Can issue charitable donation receipts to donors
  - A gift for income tax purposes permits donor to receive a partial benefit (split-receipting)
- Disadvantages of being a charity
  - Must go through a registration process
  - Subject to more regulatory oversight
- Legal forms for a charity
  - Unincorporated associations
  - Charitable trusts
  - Corporations

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- 2. NPOs
  - Paragraph 149(1)(l) of the ITA – 4 basic requirements
  - Advantages of being NPOs
    - Do not pay tax on income or capital gains, unless its main purpose is to provide dining, recreation or sporting facilities
    - Broader possible purposes than a registered charity – any purpose other than profit
    - More freedom to operate vis a vis tax rules in the ITA than registered charities, i.e., non-profits can carry out political activities without limitation
    - No requirement to register with CRA and many do not even file a tax return

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- Disadvantages of being NPOs
  - Registered charities can issue donation receipts, NPOs cannot
  - Unlike business corporations, NPOs cannot distribute earnings to members in the form of dividends or otherwise and there are limits on the nature of commercial activities that can be carried on
  - An NPO cannot carry a substantial surplus on its books from year to year (other than reasonable reserve), but a registered charity can carry a surplus (e.g., endowments)

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- Legal forms for NPOs
  - Unincorporated associations
  - Corporations
  - But probably not trusts
- Recent CRA views create much uncertainty for NPOs and substantially limit their revenue-generating capacity

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**C. CONSEQUENCES OF LOSING NPO STATUS**

- Automatically becomes a taxable entity
- A deemed year end for the corporation is created and corporation deemed to have disposed of and reacquired all of the corporation's assets for fair market value [paragraph 149(10) if the ITA]
- It also affects the corporation's ability to carry forward losses and other balances or reserves
- Members of an unincorporated NPO would become responsible for any taxable income in the organization (CRA Document 2010-036970)
- Document 2010-035583 provides a recent discussion

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**D. FOUR BASIC REQUIREMENTS FOR NPOs**

- To qualify as an NPO, organization must meet all 4 criteria under paragraph 149(1)(l) of the ITA throughout any taxation year in order to maintain tax-exempt status
  1. Not be a charity
  2. Be organized exclusively for social welfare, civic improvement, pleasure, recreation or any other purpose except profit
  3. Be operated exclusively for social welfare, civic improvement, pleasure, recreation or any other purpose except profit
  4. Not distribute or otherwise make available for the personal benefit of a member any of its income

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- It is a question of fact that can only be determined after a review of the purposes and activities of the NPO
- NPO status must generally be reviewed on a year by year basis
- Document 2010-038058117 – It is possible for an organization to qualify for exemption as an NPO for a period shorter than its fiscal year
- Being incorporated as a not-for-profit under corporate legislation does not mean that the organization is an NPO for tax purposes
- See CRA *IT-496R, Non-Profit Organizations* <http://www.cra-arc.gc.ca/E/pub/tp/it496r/README.html>

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13

1. Must not be a charity
  - If CRA considers an organization to be a "charity" as defined in subsection 149.1(1), then it cannot qualify in that period as a tax-exempt NPO
  - No explicit opinion from CRA is required and no ruling would be issued because it is always a question of fact (Document 2009-03299)
  - If an NPO is denied charitable registration, this does not automatically mean that it is not a charity
  - Document 2010-038058117 - an organization with exclusively charitable purposes does not qualify as an NPO, even if it is not a registered charity

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14

2. Must be *organized* for non-profit purposes
  - NPOs must be organized exclusively for social welfare, civic improvement, pleasure, recreation or any other purpose except profit
  - Document 2010-038058117 - NPOs may be established to further any purpose other than for a profit purpose, no requirement that an NPO must have a "benevolent" or "social" purpose
  - When determining the purpose for which an association was organized, the instruments creating the association will normally be reviewed, including letters patent, articles of incorporation, memoranda of agreement, by-laws, etc
  - Rarely an issue

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3. Must be *operated* for non-profit purposes
  - NPOs must in fact be *operated* exclusively for social welfare, civic improvement, pleasure, recreation or any other purpose except profit
  - This is the criteria that is the subject of the most uncertainty for NPOs
  - CRA is generally of the view that an NPO can engage in commercial activities and earn an unintentional profit, but if it would be unable to undertake its not-for-profit activities but for its profitable activities, the organization cannot be an NPO because it has a profit purpose (Document 2009-033731)

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- Issues
  - Carrying on a trade or business
  - Accumulating excess income
  - Earning investment income
  - Carrying on a trade or business through a wholly owned subsidiary

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- Document 2010-038058117 – summary of CRA’s view
  - NPOs must operate “exclusively” for purposes other than profit (incidental profits do not amount to a profit purpose)
  - May receive incidental profits through basic fundraising (lotteries, bake sales, chocolate bar sales, etc.) and soliciting gifts and grants
  - Can earn profits, but the profits should be incidental and arise from activities that are undertaken to meet the organization’s not-for-profit objectives (“incidental profits”)

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- Earning profits to fund not-for-profit objectives is not considered to be itself a not-for-profit objective (i.e., no destination test)
- Should fund capital projects and establish (reasonable) operating reserves from capital contributed by members, from gifts and grants, or from accumulated, incidental profits
- Capital contributions, gifts and grants, and incidental profits should generally be accumulated solely for use in the operations of the organization (including funding capital projects or setting up operating reserves) and should not be used to establish long-term reserves designed primarily to generate investment income

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- Maintaining reasonable operating reserves or bank accounts required for ordinary operations will generally be considered to be an activity undertaken to meet the not-for-profit objectives of an organization - incidental income arising from these reserves or accounts will not affect the status of an organization
- May engage in limited fundraising activities involving games of chance (e.g., lotteries, draws), or sales of donated or inexpensive goods (e.g., bake sales or plant sales, chocolate bar sales)

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- In determining whether an organization has any profit purpose, the activities of the organization must be reviewed both independently and in the context of the organization as a whole
- CRA gave the following examples of acceptable activities that result in incidental profit
  - Operation of a canteen at a hockey arena
  - Charging admission above direct cost for a children's concert (where the not-for-profit purpose of the organization was to organize and promote youth participation in music)

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4. Must not distribute income to members

- An NPO must not distribute or otherwise make available for the personal benefit of a member any of its income unless the member is a RCAA
- No part of the income of an NPO, whether current or accumulated, can be paid to a member, nor may it declare and pay dividends out of income
- An NPO may fail to comply with this requirement on a winding-up, dissolution, or amalgamation resulting in tax liability
- Certain types of payments will not, in and by themselves, disqualify an NPO, such as reasonable salaries, wages, fees or honorariums for services rendered to the NPO

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**E. INCOME TAX FILING REQUIREMENTS**

- Where an NPO is a corporation – T2 Corporation Income Tax Return (or a T2 Short Return for eligible corporations) filed within 6 months from the end of the corporation's taxation year
- NPOs whose main purpose is to provide dining, recreational or sporting facilities for its members - an *inter vivos* trust is deemed to have been created for its property income and T3 Return filed within 90 days from the end of the deemed trust's taxation year (if there is property income or has disposed of capital property that is not used directly in the course of providing dining, recreational or sporting facilities to its members)

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- NPOs (incorporated or unincorporated) must also file Form T1044 information return within 6 months after year end if
  - Has more than \$10,000 in taxable dividends, interest, rentals or royalties received or receivable in the fiscal period;
  - Has more than \$200,000 in assets at the end of the preceding fiscal period; or
  - Had to file an NPO information return for a preceding fiscal period

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- An NPO that is a Registered Canadian Amateur Athletic Association ("RCAAA") does not need to file Form T1044, but must file Form T2052 information return within 6 months of its fiscal year end
- Certain NPOs may not need to file any forms for a particular taxation year if none of the above apply

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**F. CRA ACTIONS**

- See CRA Roundtable at the 2010 Canadian Tax Foundation Conference, slides 60-62
- The NPO Risk Identification Project is gathering information to assist in determining “the level of non-compliance, any significant data gaps that may require mandatory filing of prescribed forms, and whether recommendations to the Department of Finance for more robust legislation are necessary”
- The NPO project will help the CRA find out what it knows and does not know

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- In respect of NPO compliance, the CRA stated that an NPO that is carrying on a business for profit may remain non-taxable if its meets the requirements of paragraph 149(1)(l)
- For example
  - Operation of a canteen at a hockey arena that results in incidental profit would be acceptable
  - But an NPO’s business activities cannot be designed to be a driving force of the entity’s existence and cannot be the NPO’s principle objective

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**G. SOME PRACTICAL ISSUES/COMMENTS**

- Questions to ask:
  - Does the organization continue to meet the definition of a non-profit organization under the ITA?
  - Are the organization’s objects sufficient to ensure that it is not a charity, e.g., by including in its objects a disqualifying clause such as lobbying for legislative change?

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- Does the organization earn a profit from a particular activity? If so, is the earning of the profit incidental or intentional, how much profit is earned from each activity and what is the profit used for?
- Does the organization maintain reserves in excess of a reasonable level acceptable to CRA?
- Be careful about how capital projects are funded, CRA suggests this may only occur through increased member fees
- Does the organization carry out revenue activity within a taxable entity? If so, governance issues will need to be carefully considered
- Is the organization filing all required income tax forms?

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**H. CONCLUSION**

- Recent CRA views create much uncertainty for NPOs and substantially limit their revenue-generating capacity
- While these views are open to challenge on the basis that they contradict existing jurisprudence, NPOs seeking to comply will have to look closely at their revenue-generating activities and take proactive measures to ensure that they are not caught offside the CRA's recent administrative positions

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