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# THE 2008 ANNUAL CHURCH & CHARITY LAW™ SEMINAR

Toronto – November 6, 2008

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## Charity, Business and Profit: A Contradiction in Terms?

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By Theresa L.M. Man, B.Sc., M.Mus., LL.B., LL.M.

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A Contradiction in Terms?

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INTRODUCTION

- Can charities make money?
- Ground rules for business activities
  - Charitable organizations and public foundations are permitted to conduct related businesses, but not unrelated businesses
  - Private foundations cannot operate any businesses

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WHY IS THIS ISSUE IMPORTANT?

- Provides an income stream for charities, but must be conducted within rules under the *Income Tax Act* and CRA's policies
- Affects calculation of disbursement quota
- Affects compliance with the proposed fundraising policy
- Affects completion of T3010 annual return
- Violation may lead to penalties or revocation of charitable status

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**CONSEQUENCES OF OPERATING AN UNRELATED BUSINESS**

- Penalty of 5% of the gross income from the unrelated business
- Penalty of 100% of the gross income from the unrelated business and suspension of receipting privileges if repeat infraction within 5 years
- Revocation of charitable status

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**TWO KINDS OF RELATED BUSINESSES**

- Businesses that are run substantially by volunteers
- Businesses that are linked to a charity's purpose and subordinate to that purpose
- CRA's Policy Statement "What is a Related Business?" CPS-019, March 31, 2003  
<http://www.cra-arc.gc.ca/tax/charities/menu-e.html>

**FOLLOW THE "DECISION-TREE" IN CRA'S POLICY**

- Part I - Is a particular activity a business carried on by the charity?
- Part II - Is the business of a charity an unrelated business?

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**PART I - IS A PARTICULAR ACTIVITY A BUSINESS CARRIED ON BY THE CHARITY?**

- Decision tree question (1): Is the activity commercial in nature? – i.e. does the charity derive revenue from the provision of goods and services?
- Decision tree question (2): Does the charity intend to profit from the activity?
  - If no to either (1) and (2), then it is not a business
  - If yes to both (1) and (2), then go to question (3)

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- **Decision tree question (3): Is the activity simply the sale of donated goods?**
  - If yes, then it is not a business
  - If no, then go to question (4)
- **Decision tree question (4): Is the activity carried on in a systematic, regular basis?**
  - If no, then it is not a business
  - If yes, then it is a business and go to Part II to determine whether the business is related or unrelated

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- WHAT IS A “BUSINESS”?**
- A related business must be a “business”
  - A “business” involves commercial activity (derives revenues from providing goods or services) undertaken with the intention to earn profit
  - Factors
    - Intended course of action – i.e. whether the rationale for operating a given activity is to generate a profit

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- Potential to earn a profit – i.e. whether the activity is structured so that it is capable of earning a profit
- Existence of profit in the past
- Expertise and experience of the person or organization that undertakes the activity – i.e. the person or organization has been selected because of commercial knowledge, skill, or experience

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- **Income-earning activities that are not “businesses”**
  - Soliciting donations
  - Selling donated goods
  - Charitable activities that charge fees
    - The fee structure is designed to defray the costs of the program rather than to generate a profit
    - The program does not offer services comparable to those otherwise available in the marketplace

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- The fees are set according to a charitable objective as opposed to a market objective – e.g. charging fees according to users’ means, or waiving admission charges to an art exhibit
- e.g. low-income housing rents, university tuition fees, museum admission
- e.g. micro-enterprise programs, training businesses, social businesses (see CRA’s *Guide* RC4143(E), “Community Economic Development Programs,” December 23, 1999)

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- WHAT IS “CARRYING ON” A BUSINESS?**
- “Carrying on” a business implies that the commercial activity is a continuous or regular operation
- WHAT IS NOT “CARRYING ON” A BUSINESS?**
- Occasional business activities that are not operated regularly or continuously
  - Most fundraising activities (although they usually are business activities)
    - A fundraising event has clear start and end points, but carrying on a business implies continuous operations

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- A fundraising event of a particular type does not recur with such regularity and frequency that it amounts to carrying on a business
- CRA proposed fundraising policy on June 20, 2008 – needs to ensure what is intended to be business activities from the perspective of the charities is not recognized as fundraising activities, and vice versa

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- Earning passive investments
  - Derived primarily from the mere ownership of an asset - not dependent on active trading (buying or selling of a product) or exploitation of an asset (e.g. manufacturers or resource companies)
  - Risk to the charity is generally limited to the purchase price of the asset
  - A passive activity
  - Ownership of a partnership interest is a business activity

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**PART II - IS THE BUSINESS OF A CHARITY AN UNRELATED BUSINESS?**

- Decision tree question (5): Are substantially all the people running the business volunteers?
  - If yes, then the charity is carrying on a related business
  - If no, then go to question (6)
- Decision tree question (6): Are the business activities linked to the charity's purpose?
  - If no, then the charity is carrying on an unrelated business
  - If yes, then go on to question (7)

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- **Decision tree question (7): Are the business activities subordinate to a dominant charitable purpose?**
  - If no, then the charity is carrying on an unrelated business
  - If yes, then the charity is carrying on a related business

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**RELATED BUSINESSES THAT ARE SUBSTANTIALLY RUN BY VOLUNTEERS**

- A business that has “substantially” all those “employed” in the business serving as unpaid volunteers, regardless of whether the business is related to the charity’s objects
- “Substantially all” means 90%
- The people “employed” means the people the charity “uses” to operate the business - include employees and contract workers
- Based on head count

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**RELATED BUSINESSES THAT ARE LINKED TO A CHARITY’S PURPOSE AND SUBORDINATE TO THAT PURPOSE**

- When is a business “linked” to a charity’s purpose?
  - Must fit within 1 of 4 forms of linkage
  - 1) Usual and necessary concomitant of charitable programs
    - Supplements the charity’s charitable programs, either because they are necessary for the effective operation of the program or they improve the quality of the service delivered by the programs
    - e.g. hospital’s parking lots, art gallery’s gift shop, university bookstores

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**2) Off-shoot of a charitable program**

- A charity creating an asset in the ordinary course of its operations, as a by-product of its programs
- e.g. a church selling recordings of its choir singing at its services

**3) Use of excess capacity**

- Using a charity's staff and resources to gain income during periods when they are not being used to their full capacity within the charitable program
- e.g. universities renting out residences in the summer months

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**4) Sale of items that promote the charity or its objects**

- Sale of items that advertise, promote, or symbolize the charity and do not compete directly with products produced and sold for for-profit entities
- e.g. Girl Guides selling cookies

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- When is a business “subordinate” to a dominant charitable purpose of the charity?
  - If it remains subservient to a dominant charitable purpose, as opposed to becoming non-charitable purpose in its own right – four factors to consider:
    - 1) The business activity receives a minor portion of the charity's attention and resources
    - 2) The business is integrated to the charity's operations, rather than acting as a self-contained unit

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3) The organization’s charitable goals continue to dominate its decision-making

4) The organization continues to operate for an exclusively charitable purpose by not permitting any private benefit to enter into its operations

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**OTHER RESTRICTIONS ON OPERATING RELATED BUSINESSES**

- Disbursement quota
  - Only monies spent directly on charitable activities or on gifts to qualified donees would be counted towards meeting the disbursement quota
  - Expenditure on operating a related business activity would not be counted towards meeting the disbursement quota
  - A charity must be careful that its expenditure on related business activities would not cause the charity to not meet its disbursement quota requirements

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- *Charitable Gifts Act (Ontario)*
  - Prohibits charities from owning more than 10% of an “interest in a business”
  - If a charity owns more than 10% interest of a business, it would have to dispose all interest in excess of 10% within 7 years - possible to obtain a court order to extend the 7-year period

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- If a charity owns more than 50% interest of a business, the financial statements of the business and other financial information will need to be filed with the Ontario Public Guardian and Trustee by March 31st of each year and 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
- Not apply to organizations of a religious denomination
- Vague and broad statutory definition of "interest in a business" in the legislation
- Broad application by the courts and PGT

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- *Charities Accounting Act (Ontario)*
  - Prohibits a charity to from holding real property for over 3 years, if 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
  - 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

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- 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
- This restriction would limit the ability of charities to lease out extensive surplus real property for an income stream for over three years, or develop surplus property for commercial use in return for an income stream

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- *Trustee Act (Ontario)*
  - Requires a trustee to exercise the care, skill, diligence and judgment that a prudent investor would exercise in making investments
  - Charities must ensure that the business interests they hold comply with the standard imposed by the *Trustee Act*

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**ALTERNATIVES TO OPERATE AN UNRELATED BUSINESS**

- Use of intermediary entities
- e.g. 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 option has pros and cons

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**1. For-profit Company**

- CRA's related business policy suggests that if a charity establishes a separate taxable corporation, it can invest in the corporation on the same basis that it can invest in any other for-profit business
- Utilize a for-profit company to operate the business or own revenue generating real property
- Charity to control or influence the company
- However, in Ontario, the charity cannot own more than 10% of the shares of the company

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- The for-profit company can donate its profits, pay dividends, make other appropriate payments (e.g. rent, license fees) to the charity
- The for-profit company to pay tax on its profits

2. Non-profit Corporation

- Under limited circumstances, may utilize a non-share capital corporation that would be a tax-exempt non-profit organization (“NPO”)
- However, the application of this option may be limited, since NPOs are generally not permitted to carry on businesses to earn profits

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3. Business Trust

- A business trust may be used
- 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, income that is distributed by the trust to the charity as a beneficiary would not be subject to tax

4. Combination

- Mix-and-match of the above
- Possibly complicated arrangements

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**LOOKING FORWARD?**

- Social enterprise – a rapid global development in the past two decades
- Some governments have taken steps in enacting legislation to encourage the continued development of social enterprise, e.g.
  - In 2005, the United Kingdom passed new legislation to allow the creation of a new type of company for social enterprises known as the “Community Interest Company”

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- In the United States, 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” – similar legislation proposed in North Carolina
- In Canada, there has also been a rise in the interest in developing social enterprise
- Canadian regulatory regime for registered charities is very restrictive of their ability to engage in business activities, let alone social enterprise activities
- There is a movement to propose legislation to allow the creation of a hybrid entity that can be used to operate social enterprises

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