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BUSINESS ACTIVITIES – RAISING REVENUE THROUGH BUSINESS ACTIVITIES WITHOUT VIOLATING LEGAL PRINCIPLES: PART 3

By Donald J. Bourgeois *

This is the third in a series reviewing business activities and legal principles for charitable and not-for-profit organizations in Canada. In *Charity Law Bulletin* No. 196, the issue was introduced and focussed on charitable organizations. The discussion was continued in *Charity Law Bulletin* No. 200 with an examination of Canada Revenue Agency's Guidance with respect to business activities.[1] This *Charity Law Bulletin* will discuss business activities in context of not-for-profit organizations.

A not-for-profit organization may be similar, in many cases, to a charitable organization but in law the two are distinct. Many not-for-profit organizations, for example, have objects and activities that are to benefit the community in which the members reside. Another group of not-for-profit organizations exist to provide programs and services that are to provide benefits to their members – chambers of commerce, trade organizations, golf and curling clubs, and so forth are some examples of this group. All not-for-profit

* Donald J. Bourgeois, B.A., LL.B., is counsel to Carters Professional Corporation on charitable matters.

[1] It should be noted that, for charitable organizations, the importance of CRA "Guidance" may have been elevated in the Federal Budget of March 2010. That Budget, which announced the elimination of the disbursement quota for charitable organizations, also emphasized CRA's guidance. The Budget papers commented that one reason to eliminate the disbursement quota was because CRA's "ability to ensure appropriateness of a charity's fundraising and other practices has been strengthened through the introduction of new legislative and administrative compliance measures and the provision of additional resources." The guidance on fundraising is specifically mentioned as one of the initiatives from CRA. See Chapter 3.4 of the *Budget Plan*, "Supporting Families and Communities and Standing Up for Those Who Helped Build Canada", pages 128 – 129. The *Budget Plan* and its various papers are at http://www.budget.gc.ca/2010/plan/toc-tdm-eng.html.

organizations have one key element in common – the organization does not distribute its income to its members.

Section 149(1)(l) of the *Income Tax Act* provides that a "non-profit" organization is a club, society or association that, in the opinion of the Minister, was not a charity within the meaning assigned by s. 149.1(1). Further, the organization must have been organized and operated exclusively for social welfare, civic improvement, pleasure or recreation or any other purpose except profit, no part of the income of which was payable to, or was otherwise available, for the personal benefit of, any proprietor, member or shareholder thereof unless the proprietor, member or shareholder was a club, society or association the primary purpose and function of which was the promotion of amateur athletics in Canada.[2] This definition, as is so much in income taxation, is both "negative", i.e., what it is not, and a bit convoluted.

Nonetheless, there is a clear theme – profits from operations or activities cannot be given to the proprietor, member or shareholder. Interestingly, the legislation does refer to "proprietor" and "shareholder", which seems to be inconsistent with the overall theme. However, there are a number of corporations that were incorporated under older legislation in which the "members" own shares to represent their investment in the capital of the corporation, i.e., to purchase membership in a golf or curling club. The shareholders would not receive "dividends" or similar income from their shareholdings but would be able to obtain the value of the shareholdings if they leave the corporation.

Generally, the income on not-for-profit organizations is not taxable, either at the federal or provincial level. There may also be other tax exemptions or rebates available for the organization depending upon the jurisdiction in which it operates or has its head office or the types of activities it undertakes. These exemptions from or rebates for retail sales taxation, goods and services taxation (or the harmonized sales taxation scheme in place in some provinces and to be extended to Ontario and British Columbia in July 2010), property taxation, and land transfer taxation are very complicated and fact specific.[3]

Canada Revenue Agency uses several indicators in assessing whether an organization is operated exclusively for not-for-profit purposes or is carrying on a trade or business. The fact that the organization is incorporated

[2] Canada Revenue Agency, *Non-profit Organizations*, IT-496R, August 2, 2001.

[3] See Donald J. Bourgeois, "Charities, Associations and Not-for-Profit Organizations" in *Halsbury's Laws of Canada*, 1st edition, Markham: LexisNexis Inc., 2008 for an overview.

as a corporation without share capital and has only not-for-profit objects is not decisive. CRA also takes into account if:

- the organization's activities are a trade or business in the ordinary meaning such that it is operated in a normal commercial manner,
- the organization's goods or services are not restricted to members and guests but are more broadly available,
- the organization's operations are on a profit basis rather than a cost recovery basis, and
- the organization's operations are in competition with taxable entities carrying on the same trade or business.

These factors are, of course, very much fact-based and are not necessarily conclusive alone. For example, while the third factor above would suggest that an organization cannot have a surplus or "profit" from an activity, there can be an excess in income over expenditures. A material part of the excess must not be accumulated each year and the balance of the accumulated excess must not be greater than the organization's reasonable needs. Incidental profits are also not necessarily decisive. And an organization may be in competition with taxable entities, but it is important to examine the full context to understand why and how it is in competition. It will certainly be different if the organization is providing insurance coverage to the members of a trade or professional organization as opposed to doing so in the "open market".

An organization that is not a corporation is not required to file an annual return under the *Income Tax Act* unless it has certain types of income. A corporation is required to file an annual return regardless of the types of income. It may not be required to pay income tax, but it still has a legal obligation to file a return. If the not-for-profit organization's main purpose is to provide dining, recreation or sporting facilities for its members (such as a golf club), income from property in excess of $2,000 will be taxed. The organization, under subsection 149(5) of the *Income Tax Act* is deemed to be a trustee of an *inter vivos* trust for the property that gave rise to the income. A not-for-profit organization is also required to file an annual return under subsection 149(12) if it (i) receives more than $10,000 in interest, rentals or royalties, (ii) has more than $200,000 in assets at the of the preceding fiscal period, or (iii) was required to file the return in any preceding fiscal period. In other words, once an organization that was otherwise exempt from filing is required to file, it must do so thereafter regardless if it otherwise falls into the exemption.

The above, while complicated at times, was generally understandable. CRA has recently made the situation much less understandable in two Technical Interpretations – one from November 5, 2009 and the other December 15, 2009. More importantly, CRA has raised the level of risk that accrues to business activities for not-for-profit organizations. These Technical Interpretations are not "binding" interpretations of the law, as are court decisions, but they do reflect a changing perspective at Canada Revenue Agency. The changing perspective seem to flow from a 2008 case, *BBM Canada v. The Queen* 2008 D.T.C. 4129 (Tax Court of Canada).

The Technical Interpretations establish a higher standard or benchmark for not-for-profit organizations to meet to avoid taxation on any surplus of income over expenditures. Essentially, it would appear that CRA now views any profit as being problematic unless the profit or surplus was incidental and not intended. For example, CRA comments that in Technical Interpretation 2009-0337311E5, November 5, 2009:

> Paragraph 149(1)(l) requires that an organization be organized and operated "exclusively" for "any other purpose except profit" in order to be exempt from tax under that provision. In our view, the use of the word "exclusively" indicates that while an organization may have many purposes, none of those purposes may be to earn a profit. Thus, where an organization intends, at any time, to earn a profit, it will not be exempt from tax under paragraph 149(1)(l) even if it expects to use or actually uses that profit to support its not-for-profit objectives.
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> The CRA accepts that a 149(1)(l) entity can earn a profit; otherwise, the tax exemption provided would be unnecessary. Earning a profit, in and of itself, does not prevent an organization from being a 149(1)(l) entity. However, the profit should generally be unanticipated and incidental to the purpose or purposes of the organization. For example, an organization might budget with the intention of not earning a profit, but ultimately find itself with a profit because of expenses that were less than anticipated or that were reasonably expected but not actually incurred. If the original budget was reasonable, the profit earned would not, in and of itself, cause the organization to cease to be a 149(1)(l) entity.

It is very difficult, if not impossible, to reconcile the current perspective of CRA with its previous views and, equally important, with the practices that are in place. While it is not illegal to make a profit, the legal basis for the profit to be exempt from income taxation has narrowed considerably if CRA's views are correct.

Not-for-profit organizations are urged to review their situation and, where appropriate, to seek both legal and accounting advice. Ultimately, the issue will be determined on the basis of the facts and the application of the law to those facts; but it is much better to be prepared and to have a strong rationale for the "profit" within the narrower approach now being taken by CRA or to be in a position to challenge that narrower approach with a good fact situation.

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Ottawa (613) 235-4774
Mississauga (905) 306-2791
Orangeville (519) 942-0001
Toll Free: 1-877-942-0001
www.charitylaw.ca