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NPOs MAKING MONEY...AND OTHER COMPLIANCE ISSUES

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OVERVIEW

- Basics of Maintaining NPO Status
- Making Money as an NPO
- NPO Risk Identification Project
- Practical Questions

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MAINTAINING NPO STATUS

- 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
- This section 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
- Recent CRA views create much uncertainty for NPOs and substantially limit their revenue-generating capacity

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FOUR BASIC REQUIREMENTS FOR NPOs

- To qualify as an NPO, organization must meet all 4 criteria under paragraph 149(1)(l) of the *Income Tax Act* ("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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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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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, though recent audits have commented on dissolution provisions in this context

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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, particularly with respect to NPOs making money
- 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) - details later

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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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FILING REQUIREMENTS

- Where the NPO is a corporation, a T2 Corporation Income Tax Return (or a T2 Short Return for eligible corporations) must be filed within 6 months
- All NPOs must also file a Form T1044, Non-Profit Organization (NPO) Information Return in the following circumstances:
 - The total of all amounts received or receivable by the NPO in the fiscal period for taxable dividends, interest, rentals or royalties is more than \$10,000;
 - The total assets of the NPO at the end of its immediately preceding fiscal period exceeded \$200,000; or
 - The NPO had to file an NPO information return for a preceding fiscal period

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- Where subsection 149(5) of the ITA applies (generally to an NPO 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 the NPO's property income
- T3 Trust Income Tax Information Return must be filed within 90 days from the end of the deemed trust's taxation year where the deemed trust has tax payable with respect to property income, or has disposed of any capital property that is not used directly in the course of providing dining, recreational or sporting facilities to its members

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- An NPO that is also a Registered Canadian Amateur Athletic Association ("RCAAA") does not have to file a Form T1044. An RCAAA must file Form T2052, Registered Canadian Amateur Athletic Association Return of Information within 6 months of the RCAAA's fiscal year end
- Certain NPOs may not be required to file any forms for a particular taxation year if none of the conditions outlined above are met

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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) of 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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MAKING MONEY AS AN NPO

- Question: Is the NPO operating for a non-profit purpose if it is:
 - 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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- a) Carrying on a trade or business through an NPO
 - The ITA does not specifically prohibit an NPO from earning a profit or engaging in commercial activities
 - Paragraph 7 of IT-496R recognizes that "the 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" if those activities are carried on within the NPO

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- IT-496R lists some characteristics that CRA considers in determining whether an activity is a trade or business
 - a) Is it a trade or business in the ordinary meaning, e.g. operated in a normal commercial manner;
 - b) Are its goods or services restricted to members and their guests;
 - c) Is it operated on a profit basis rather than a cost recovery basis; or
 - d) Is it operated in competition with taxable entities carrying on same trade or business

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- If the activity generates a profit, CRA has indicated as follows:
 - The income generating activity cannot be the principal activity of the corporation and the resulting income must be used by the corporation in carrying out its exempt objectives (Document 1998-97046)
 - There must be a causal relationship between the profit making activity and the exempt purpose of the organization (Document 2002-01538)
 - The profit must be it is unanticipated and incidental to carrying out the NPO's exempt purposes (Document 2009-033731)

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- Document 2010-038058117 - recent 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

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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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- In CRA View 2011-0427611I7, after evaluating the information presented to it, CRA determined that the NPOs profits were consistently increasing every year, that its profits were not incidental, and that its profit margins were such that the Organization had a for profit purpose
- Of particular concern was that the NPOs members equity had also increased over the years such that CRA believed that the organization could be accumulating funds in order to earn tax-exempt investment income
- CRA concluded that the NPO had not been operating for a purpose other than profit and did not meet the requirements of paragraph 149(1)(l)

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b) Accumulating Excess Income

- IT-296R indicates that an NPO may earn income in excess of its expenditures and that the excess may result from the activity for which it was organized or from some other activity
- A one-time capital gain from disposing of property does not jeopardize NPO's status (Document [2010-035802](#))
- But, if a material part of an excess is accumulated each year and the balance of accumulated excess at any time is greater than the NPO's reasonable needs to carry on its non-profit activities the NPO will be considered to be operating for a profit

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- The amount will be considered reasonable based on the needs of the NPO, 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)
- In some circumstances, an accumulation equal to one year's reasonably anticipated expenditures on its non-profit activities may not be considered excessive, while a reserve equal to expenditures over a much shorter period would be considered more than adequate in other situations

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- If an NPO requires a time period in excess of the current and prior year to accumulate the funds needed to acquire capital property that will be used to achieve its declared exempt activities, its tax-exempt status may not be affected
- Examples include the construction of a new building to replace an existing building when it deteriorates or no longer meets the association's needs or the condo roof referred to earlier
- Potential problem arises regarding how the funds are held while being accumulated

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c) Earning Investment Income

- In *L.I.U.N.A. Local 527 Members' Training Trust Fund v. The Queen*, the court held that an NPO would have to do more than merely earning passive investment income to lose its status. The earning of such income would need to be both an operating motivation of the fund and a focus of its activity
- However, IT-496R indicates an NPO will be considered to be operating for profit if it has excess assets held in long-term investments to produce property income or in a term deposit or GIC that is regularly renewed from year to year

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- An example (Document 2010-036605)
 - CRA considered a situation where a proposed NPO intended to invest a substantial amount of cash donated to it to provide income which would be used by the NPO exclusively to pay for its cultural activities and various related operations
 - CRA confirmed that the activity of investing cash is considered to be undertaken to earn a profit, which is contrary to the conditions of the ITA. The only exception is where the income-generating assets will themselves be used directly to meet an NPO's not-for-profit objectives within a reasonable time-frame

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- In CRA View 2011-040885117, members of the organization in question were charged a commission on services provided to them, with the net profits being distributed to the members at specified times throughout the year. Because there was a difference in time between the inflow and outflow of money, the money was invested the collected money until distribution to the members occurred.
- Income from the investments was then used to defray the expenses of the organization and to keep commissions charged to its members as low as possible.
- Did the expectation of this income affect its ability to claim NPO status, especially with the organization's desire to minimize the commissions charged to its Members?

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- CRA stated that since the organization's reasons for distributing the amounts collected from users to Members was due to non-profit reasons, it was reasonable to expect that the funds would be invested
- The profit from these funds could only be used to help meet operating expenses and not to generate investment income
- If the investment income was the income of the members and not of the organization (i.e. the organization was an agent of the members with respect to the income), then the investment income would be taxed in the hands of the members and would not affect the tax status of the organization as an NPO

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- d) Carrying on a trade or business through a wholly owned subsidiary
 - CRA has indicated 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), an NPO may also derive income from a taxable subsidiary (Document 2002-0153887)
 - Also, if an NPO holds all of the shares of the capital stock of a taxable corporation, its NPO status is not necessarily endangered (Document 2001-0093245)

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RESTRICTIVE INTERPRETATION?

- Some commentators are of the view that CRA's interpretations on this question are overly restrictive: *"[T]he requirement should not be read as a prohibition against the profitable pursuit of not-for-profit purposes. If that were the intended meaning of the rule, the statutory requirement would be phrased as a prohibition against profit-making, not as a purpose test... "[I]ncidental" profits, meaning profits that are a byproduct or incident of an activity but not the activity's point, anticipated or unanticipated, generated in the pursuit of a not-for-profit purpose should be permissible under a purpose test. Consistently profitable activity is merely evidence of a profit purpose, not proof of it."*
- See David P. Stevens & Faye Kravetz, Current Developments in the Application Of Paragraph 149(1)(1) Of The *Income Tax Act*, *The Philanthropist*, 25:3 at p. 165.

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- The language simply does not deal with the anticipated use of the funds so basing a determination on whether a NPO qualifies on whether it would be unable to undertake its not-for-profit activities but for its profitable activities is without basis in the legislation and, arguably, irrelevant
- According to Stevens and Kravetz, the judicial decisions are much closer to the view that incidental profit-making and profit-making to support non-profit activities are permitted

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NPO RISK IDENTIFICATION PROJECT

- The NPO Risk Identification Project was a 3-year research project on tax compliance in the non-profit sector completed in the summer of 2013
- NPOs have been under the microscope of CRA, particularly with respect to the revenue they earn in addition to membership fees
- CRA randomly selected NPOs to review from the 39,000 NPOs that file T2, T3 and/or T1044 returns
 - Over the three years of the project, 1440 NPOs were to have been reviewed

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- Education letters issued as part of the project had caused great concern among NPO sector and prompted many discussions with CRA
- Perrin Beatty, President and CEO of the Canadian Chamber of Commerce wrote a letter on March 13, 2012 to the Minister of National Revenue expressing the concerns of the NPO sector
 - Stated CRA appeared to be unaware of impact of letters on members of NPOs

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- Mr. Beatty stated:
 - “Our concern is not with the examination, but with the lack of communications about its purpose and with the Agency’s practice of issuing “education letters” to organizations which have been audited under this process. Although the Agency has often stated that “no conclusions have been reached”, these letters inform the organizations that they are in breach of the Act, and urge them to make adjustments in their activities to comply”
- As of April 23, 2012 CRA was directed by the Minister to stop issuing the education letters and is only providing written views upon request

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- CRA now has an informative question and answer section for NPOs to consult <http://www.cra-arc.gc.ca/tx/nnprft/qa-eng.html>
- CRA states that education letters were meant to “raise awareness of the rules governing the benefits available” to NPOs under the ITA and that reassessments are only occurring in the most “egregious cases”
- CRA maintains its position that it is possible for an NPO to generate a profit but
 - the profit must be incidental; and
 - arise from activities that support the organization’s not-for-profit objectives
- Report due early in 2014

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OTHER EXEMPTIONS

- Because of concerns with respect to reserves and profit-making activities many organizations are considering whether they want to maintain NPO status and/or whether they can claim exemption from tax under other paragraphs of subsection 149(1)
- For example:
 - (c) a municipality in Canada, or a municipal or public body performing a function of government in Canada
 - Mostly Indian bands but may also include quasi-municipal/regulatory organizations

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- (e) an agricultural organization, a board of trade or a chamber of commerce, 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
 - Does this include industry associations or professional associations?
- (i) a corporation that was constituted exclusively for the purpose of providing low-cost housing accommodation for the aged
- (j) a corporation that was constituted exclusively for the purpose of carrying on or promoting scientific research and experimental development
- (k) a labour organization or society or a benevolent or fraternal benefit society or order

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SOME PRACTICAL ISSUES/QUESTIONS

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

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- What does it mean to not intend to earn a profit from a particular activity?
 - Can an NPO organize an activity with a margin? 2%, 5%, or 0%
 - CRA seems to be mandating zero-based budgeting *on each activity*
 - Many commentators take the view that this approach is wrong
 - CRA seems to be confusing the purpose of an activity with the purpose of the organization

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- 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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CONCLUSION

- Recent CRA views create much uncertainty for NPOs and substantially limit their capacity to make money
- 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
- Still remains to be seen though what the outcome of the Risk Identification Project will be and whether money making activities will be offside of CRA requirements


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