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THE OTTAWA REGION 2021

***Charity & Not-For-Profit Law* Webinar**

Thursday, February 11th, 2021

INCOME GENERATION BY CHARITIES AND NFPs: WHAT'S POSSIBLE AND WHAT'S NOT

By Terrance S. Carter, B.A., LL.B., TEP, Trademark Agent

tcarter@carters.ca
1-877-942-0001

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CARTERS PROFESSIONAL CORPORATION
TOLL FREE: 1-877-942-0001
Ottawa Toronto Orangeville
www.carters.ca www.charitylaw.ca www.antiterrorismlaw.ca

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OVERVIEW OF TOPICS

- The Importance of Income Generation
- Income Generation by Charities
- Income Generation by NFPs
- Key Takeaways

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A. THE IMPORTANCE OF INCOME GENERATION

- Given the negative impact of COVID-19 on charities and NFPs, enhancing income generation has become an important topic of discussion
- “NFP” refers to “not-for-profits” and for the purpose of this presentation focuses on “non-profit organizations” (NPOs) under par.149(1)(l) of the *Income Tax Act* (*ITA)*
- In order to facilitate income generation, it is important to understand what is permissible and what is not
- This presentation does not deal with receipting or HST/GST issues
- As well, given the complexities of the issues, the presentation provides only a general overview
- For specific fact situations, advice should be sought from a qualified professional

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B. INCOME GENERATION BY CHARITIES

1. Income Generation from Gifts

- What is a gift?
  - Voluntary transfer of property without valuable consideration
  - *E.g.* cash gifts
  - *E.g.* gifts of property
- Gifts from different donors
  - Individuals
  - Corporations and businesses
  - Qualified donees (*e.g.* public foundations)
- Donation receipts can be issued, subject to split-receipting rules to determine “eligible amount”

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2. Government Contracts, Grants & Contributions

- Important to review the terms of government contracts
- Contracts must relate to the purpose of the charity

3. Income from Charitable Programs/Sale of Goods

- Charities can earn income from their charitable programs and/or sale of goods
- Charging fees for charitable programs and/or the sale of goods will be charitable if the programs or sale of goods:
  - Serves the charity's beneficiaries;
  - Directly furthers a charitable purpose; and
  - Should be reasonable in the circumstances and typically aimed at cost recovery
- See CRA Guidances (CG-013) on Fundraising and (CG-018) on Arts Activities and Charitable Registration, as well as Policy Statement (CPS-024) Meeting the Public Benefit Test, for details

- Examples of fees for charitable programs and/or sale of goods by a charity that are generally seen as charitable:

  - *University and college tuition fees*
  - *Hospital health care services*
  - *Symphony ticket sales*
  - *Museum ticket sales*
  - *Counselling fees*
  - *Rent from low income housing*
  - *Fees from long-term care facilities*
  - *Sale of religious literature*
  - *Sale of medical support devices*

- If profits occur, charities can keep the profits

- No charitable donation receipts can be issued because value is being received in return

4. Income from Social Businesses

- Charities can earn income from running a business to provide permanent employment for individuals with disabilities
  - Must employ only individuals with disabilities, except for training staff and supervisors
- Charities can also earn income from employment related training that relieves unemployment
- See CRA Guidance (CG-014) on Community Economic Development (CED) for details

5. Income from Membership Fees

- Charities can earn income from membership fees
- Charitable donation receipts can be issued for the "eligible amount" of membership fees

6. Income from Conference Fees

- Charities can earn income from conference fees for in-person and virtual conferences tied to their purposes
- No donation receipts can be issued, because value is being received in return

7. Income from Sponsorships

- Charities can earn income from sponsorships provided that they are done on an irregular basis
- No donation receipt can be issued, but businesses can claim a tax deduction for sponsorship, subject to the reasonableness of the expenses claimed

8. Income from Lotteries/Raffles

- Games of chance *e.g.* bingo, Nevada tickets, *etc.*
- No donation receipt can be issued

9. Income from Fundraising Events

- Galas, dinners, auctions, concerts, golf tournaments
- Crowdfunding campaigns and other online events
- Donation receipts can be issued but are subject to split-receipting rules in determining "eligible amount"

10. Income from Fundraising by Third Parties

- Charities can earn income from third-party fundraising events, either in person or on the internet, *e.g.* a P2P campaign
- However, the charity must remain in control of tax receipting and be able to account for all income
- Important to have a written agreement in place with the third party undertaking the fundraising

11. Income from Passive Investments

- Charities can earn income from passive investments arising from "mere ownership" of property
- Investment income includes interest, dividends, royalties, or rental income involving basic services
- Investments generally must meet the prudent investor standard under the *Trustee Act* (Ont.) or other provinces
- Investment income may also come from "social investments" or "impact investments" where there is a dual purpose of financial return and charitable purpose(s)
  - In Ontario, the requirements for a "social investment" under the *Charities Accounting Act* may apply
  - "Program Related Investment" (PRI) rules under CRA (CG-014) CED Guidance may also apply

12. Income from "Related Business"

- CRA permits charitable organizations and public foundations to carry on "related businesses"
- However, private foundations cannot carry on any business activities ("related business" or otherwise)
- With a "related business", there is no requirement that the charity price the sale of products or services on a cost recovery basis
- Non-compliance, though, resulting from engaging in businesses that are not a "related business" can result in penalties and even revocation
- See CRA Policy (CPS-019) What is a Related Business?
- A "related business" is a business that is either:
  - Substantially run by volunteers (90%); or
  - Linked and subordinate to a charity's purpose

a) Substantially run by volunteers

❖ "Related Business" is defined in the ITA to include a business that is unrelated to the objects of the charity provided that it is run substantially (90%) by volunteers

- 90% volunteer determination is based on a head count done on an annual basis
- *E.g.* calculation is based on the number of people used to operate the business rather than the number of hours worked
- A business run by 90% volunteers can be unrelated to the charitable purpose (like PEI church lobster dinners)

b) Linked and subordinate to charitable purposes

- ❖ Four forms of linkage identified by CRA:
  - – A usual and necessary concomitant of charitable programs;
    - Business activities that supplement a charity's charitable programs, like a hospital cafeteria
  - – An off-shoot of a charitable program;
    - Charity may create an asset it can sell in the ordinary operation of charitable programs
  - – A use of excess capacity;
    - Earns income during the periods when assets and staff are not being used to full capacity
  - – Sale of items that promote the charity or its objects;
    - Involves sales that are intended to advertise, promote, or symbolize the charity or its objects

c) Factors that indicate subordination to the charitable purpose:

- – The business receives a minor portion of the charity's attention and resources;
- – The business is integrated into the charity's operation (not acting as a self-contained unit);
- – The charity's charitable goals continue to dominate its decision-making; or
- – The charity continues to operate for an exclusively charitable purpose by permitting no element of undue private benefit to enter into its operations

13. Income from a For-Profit Subsidiary Corporation

a) Generally

- In order to avoid a charity carrying on an "unrelated business" with resulting penalties and possible revocation, a charity could consider incorporating a for-profit subsidiary corporation in order to operate an "unrelated business"
- A subsidiary corporation could also be effective in containing liability within the subsidiary corporation
- However, in setting up a subsidiary corporation, there are a number of factors that would need to be carefully considered, including those listed on the next slides:

i. Tax Liability Under *ITA*
   - Tax would have to be paid on income earned but generally may claim a deduction for donations up to 75% of net income
   - As well, some management service fees and sponsorship fees may be charged by the charity to reduce taxable income of the for-profit subsidiary
   - Resulting <u>tax</u> from placing "unrelated business" activity in a for-profit subsidiary may be quite low, depending on the circumstances

ii. Charity Needs to Receive FMV for the Use of Any of Its Resources
   - The charity cannot simply gift resources to its for-profit subsidiary
   - Instead resources transferred must be done at FMV

iii. Charity Owning an Interest in a Business

- The charity would need to justify the investment of charitable resources as either:

Meeting the prudent investor standard under applicable provincial *Trustee Acts*

OR

A Program Related Investment under the CRA's CED Guidance, and possibly as a "social investment" in Ontario under the *Charities Accounting Act*

- In Ontario, PGT has the right under the *Charities Accounting Act* to make inquiries where the charity owns a "substantial interest" in a business (20%)

iv. Restrictions on Foundations Owning a For-Profit Business Corporation

- Public and private foundations cannot acquire more than 50% of issued share capital with full voting rights
- However, shares may be gifted to a foundation (regardless of the percentage) as long as the foundation does not acquire more than 5% of the shares for consideration
- Private foundations are subject to excess corporate holding rules requiring public disclosure over 2% and divestment requirements over 20%

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C. INCOME GENERATION BY NFPS

1. Requirements to Be an NPO

- For a NFP to qualify as an NPO under the *ITA*, an organization must meet all 4 requirements under par. 149(1)(l) of the *ITA* throughout each taxation year

1. Not be a charity (registered or common law)
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 any income for the personal benefit of a member

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- Tax exempt status under par. 149(1)(l) of the *ITA* is a question of fact that can only be determined after a review of the purposes and activities of the NPO
- CRA is generally of the view that an NPO can engage in income-generating activities and earn a profit, provided that the profit is unanticipated and unintentional
- NPOs can also engage in limited fundraising activities
- NPOs can maintain reasonable operating reserves
- See CRA IT-496R Non-Profit Organizations for historical position on NPOs
- CRA current rules on profit generation by NPOs is in a state of flux as a result of inconsistent CRA rulings and interpretations
- Therefore, difficult to know with any certainty what is acceptable income generation by NPOs and what is not

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2. Income Generation Generally Associated with Cost Recovery Activities and/or Reasonable Reserves

- Membership fees
- Sale of goods & services to members tied to the non-profit purpose of the NPO
- Fees for training courses
- Conference fees
- Sponsorship fees
- Fundraising events
- Investment income from reasonable reserves

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3. Income from a For-Profit Subsidiary Corporation

a) Generally

- In order for a NFP to avoid carrying on for-profit business activities that could jeopardize its tax exempt status as an NPO, a NFP could consider using a for-profit subsidiary corporation
- CRA has indicated that an NPO can earn income from owning a for-profit subsidiary corporation
- However, the availability of this option depends on the facts of each case
- For instance, an NPO using “excess funds” to purchase shares and/or make loans to a taxable subsidiary may be viewed as having a profit motive, since CRA may see that the NPO has raised more funds than needed to do its non-profit work

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b) Tax Liability

- Tax would have to be paid on the income earned by the subsidiary for-profit corporation
- However, unlike a charity, it is not possible to make a tax deductible donation from the subsidiary corporation to the NPO parent corporation
- Some management service fees, licence fees and sponsorship fees, though, may be charged by the NPO to the for-profit subsidiary to reduce income of the for-profit subsidiary and therefore its net income for tax purposes

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D. KEY TAKEAWAYS

- ✓ There are numerous opportunities available for income generation by charities & NFPs
- ✓ Charities in particular have a number of options to earn income that may not always be fully understood
- ✓ NFPs have more restricted opportunities to earn income because of the requirement “any purpose other than profit”
- ✓ Where a charity or NFP is not able to carry out a type of income generation, then a for-profit subsidiary corporation may be an option to consider
- ✓ The “devil is in the details”, so it is important to know the rules

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