ONTARIO NONPROFIT NETWORK

The Income Tax Act and public benefit nonprofits: Enabling financial sustainability

Issue

How to amend the Income Tax Act (ITA) to enable nonprofits to serve their communities in a financially sustainable way while mitigating the risk of tax evasion and the misuse of the nonprofit tax status.

Problem: Nonprofits need access to flexible reserves for emergencies and diverse sources of revenue for long-term growth but the ITA discourages both.

The COVID-19 pandemic, the Senate Report on the Charitable Sector, and the Social Innovation and Social Finance Strategy have all made obvious the need for nonprofits to have substantial reserves in order to respond to crises and more effectively pursue their missions.[1] Furthermore, as nonprofits continue to grapple with rising demand for services, it will be vital to access all types of possible funding by increasing the capacity of organizations to pursue earned revenue.[2] However, the Canada Revenue Agency's (CRA) current interpretation of the definition of "non-profit organization" under s.149(1)(l) of the ITA discourages nonprofits from doing either.[3]

1. **The CRA allows for "reasonable reserves" but creates a chilling effect by not defining this clearly**. CRA has recently reiterated its interpretation of the ITA and case law that a reserve which exceeds a "reasonable operating reserve" will likely indicate a profit purpose. The CRA states that what is considered reasonable will vary from case to case. While the lack of specificity is understandable given the variety of potential factors that may go into an assessment, the effect on Canadian society is unfortunate, as it pushes nonprofits to err on the side of holding lower reserves for fear that theirs will be considered excessive.
2. **The CRA only allows for surplus over expenses if they are "incidental" to the nonprofit purpose.** CRA has said in the past that one of the indicators that the nonprofit is carrying on a taxable business is the individual activity is operated on a profit rather than

[1] For example, ONN's 2023 Sector Survey found that 28% of respondents had to use their reserve, a 3% increase over 2021.
[2] ONN's 2023 Sector Survey found that increases in earned income was the second most important factor contributing to increases in respondents' revenue after increases in government funding.
[3] See DOC 2019-0825751E5 Ann Townsend (Feb 26, 2021) "Whether a NPO has a profit purpose". Canada Revenue Agency for the most recent statement of this position. Available at: https://www.canadiancharitylaw.ca/wp-content/uploads/2021/10/CRA-Views-2019-0825751E5-Whether-a-NPO-has-a-profit-purpose-Section-1491l-1.pdf

cost-recovery basis (even where the organization as a whole is operated on a break-even basis). While only one contextual indicator, this position effectively discourages nonprofits from becoming financially sustainable in part by pursuing earned revenue at a time when the Government of Canada is encouraging such activities, through, for example, the Social Finance Fund.

In practice, many nonprofits simply cannot comply with these rules and be financially sustainable. Consequently, they are forced to operate in a non-compliant manner. In 2013, the CRA studied the level of compliance with the ITA among nonprofit organizations and found a startling non-compliance rate of ~43.5%.[4] This is a clear indication that the current rules are out of step with realities on the ground. If these rules were systematically enforced, it would create a crisis in the nonprofit sector as many organizations would have to shut down as a result of the back taxes owed. The fact that they are not systematically enforced can only negatively affect public trust in the CRA's ability to fulfill its important role, and creates an uneven playing field between those who wish to comply, those who are unable to comply, and those who intentionally take advantage of this gap.

Notwithstanding the above issues, these rules are understandable given the risk that some groups will want to present themselves as nonprofits to take advantage of the tax-exempt status only to conduct business for their private profit. For example, a privately controlled nonprofit that grants no-interest loans to its members (or if they do charge interest, never collects it).[5] Such organizations are a threat not only to the tax base but to public trust in the nonprofit sector. Consequently, all stakeholders have an interest in an ITA which precludes abuse and a regulator empowered to appropriately enforce the ITA.

Solution: Allow nonprofits to accrue surpluses if their purpose is public benefit, they make publicly accessible filings annually, and they adopt a meaningful asset lock.

ONN recommends that an additional subsection be added to s.149(1) termed "public benefit non-share capital organization" which would allow for surpluses earned from the commercial activities of non-share capital corporations, trusts, or associations to be exempt from tax where:

- The profit *purpose* (disclosed by the intentional earning of a surplus) is incidental to a public benefit purpose.
- The organization makes an annual filing, information from which is available to the public, similar to that available through the annual filing for charities.
- No part of the income may be payable to, or otherwise available for the personal benefit of, any proprietor, member, shareholder, or beneficiary thereof and that in the event of such a distribution, penalties would apply to both the organization and recipient equal to

[4] Canada Revenue Agency (February 2013) NON-PROFIT ORGANIZATION RISK IDENTIFICATION PROJECT: FINAL REPORT. Available at: https://www.canadiancharitylaw.ca/blog/the_non_profit_organization_risk_identification_project_nporip_report_final/

[5] This would arguably sidestep existing protections against such provisions tailored to capture benefits conferred by for-profits on shareholders.

the amount distributed plus an additional amount calculated to economically disincentivize such inappropriate distributions.[6]

Nonprofit organizations who are not able or do not wish to meet the above criteria would continue to benefit from the existing exemption under s.149(1)(l).

Overall, this change would:

- **Support Canada's social finance strategy, recovery, and emergency preparedness.** The above proposal creates a more flexible framework in which public benefit nonprofits can create adequate reserves without fear and pursue fiscal sustainability through earned revenue all while keeping public benefit purposes paramount.
- **Prevent abuse through transparency and an even stronger safeguard against the distribution of property for private benefit.** Currently, members who wish to sell off the assets and distribute the earnings amongst themselves must pay taxes, but no more than they would face as for-profits. A meaningful asset lock would more effectively ensure that assets which have benefited from tax-exempt status in past years do not result in inappropriate private benefit, while respecting the property interests in member benefit nonprofits. For example, the return could include information on non-arm's length persons with material contracts with the nonprofit.
- **Present minimal implementation difficulties as it would exclusively involve concepts CRA already regularly applies in the charities context**. This would minimize the difficulty in the policy development process and minimize the necessary recruitment and training for staff equipped to apply this provision.

Below we will explore each of the novel elements of the proposal in greater detail, including the benefits of each element.

1. The Profit *Purpose* Must be Incidental to a Primary Public Benefit Purpose.

The CRA interprets the case law as having consistently rejected a destination of funds test, wherein profits are tax exempt merely because they are reinvested in a nonprofit purpose.[7] Our first proposed criterion narrows the rejected destination of funds test in two crucial respects which both better reflect the realities of the sector yet guard against the misuse of this provision. Firstly, it narrows the range of purposes towards which surpluses may be applied to exclusively public benefit purposes. Secondly, it requires a tighter connection between the profit-earning activity and the public benefit purpose than simply the application of funds, by requiring that the business be ancillary and incidental to the public benefit purpose. We offer a brief explanation of "public benefit" and "incidental" below.

<u>Public Benefit: Drawing on Charity Law Without Being Restricted to Outdated Precedent.</u>

The Canada Revenue Agency defines public benefit at length in "Guidelines for registering a charity: Meeting the public benefit test" and is already experienced at applying the concept of

[6] See Appendix 1 for suggested legislative drafting

[7] *BBM Canada (formerly BBM Bureau of Measurement) v. The Queen*, 2008 TCC 341 (CanLII) at para 40

"public benefit" as a necessary but not sufficient condition to be registered as a charity.[8] While all charitable purposes provide public benefit, not all public benefit purposes are charitable. For example, the Supreme Court of Canada has implicitly recognized sports organizations and immigration support services as potentially providing public benefit without necessarily being charitable.[9]

The legal difference between a public benefit purpose and a charitable purpose is that to be charitable a purpose must have been recognized by a past court case or be analogous to a purpose recognized by a past court case. A public benefit purpose can be recognized by applying the principled test of public benefit. This allows for a more flexible and contemporary approach to recognizing nonprofits whose aims are to benefit the community. We are not suggesting any changes to the meaning of public benefit already recognized in the common law and applied in statutes across Canada.[10]

There are compelling tax policy grounds for distinguishing between organizations whose benefits accrue to private individuals and those that accrue to the public at large.

<u>What does it mean for a profit purpose to be incidental to a public benefit purpose?</u>
While intentionally earning a profit or accumulating excessive reserves may disclose a profit purpose, we may further ask whether the profit purpose it discloses is itself incidental to the public benefit purpose. "Incidental" does not mean just a small or unintentional amount (though this would be strong evidence that an amount was incidental), nor does "incidental" mean any business and any amount of profit as long as it may one day theoretically be applied to a public benefit purpose as this clearly opens the door too wide to misuse of the provision. Rather, a profit purpose may be incidental to a public benefit purpose if it is pursued only as a means to the further public benefit purpose as an end.[11]

In practice, this would require nonprofits to be able to justify decisions about the way they have made profit with exclusive reference to the public benefit end. For example, the public benefit purpose would be able to explain decisions such as the following in terms of their overriding commitment to their public benefit purpose:

- The type of business
- The extent of resources dedicated to it
- The clientele and pricing strategy

[8] CPS-024 (March 10, 2006). Guidelines for registering a charity: Meeting the public benefit test. Government of Canada. Available at: https://www.canada.ca/en/revenue-agency/services/charities-giving/charities/policies-guidance/policy-statement-024-guidelines-registering-a-charity-meeting-public-benefit-test.html

[9] A.Y.S.A. Amateur Youth Soccer Association v. Canada (Revenue Agency), 2007 SCC 42 (CanLII), [2007] 3 SCR 217 at para 7. ; *Vancouver Society of Immigrant and Visible Minority Women v. M.N.R.*, 1999 CanLII 704 (SCC), [1999] 1 SCR 10 at para 179.

[10] See for example Volunteer Protection Act, SNS 2002, c 14 s.2(f)

[11] Vancouver Society ibid. at para 152.

- How the product is made
- Their relationship with other parties in the activity, especially those not at arm's length.

For example, an employment service agency for refugees and im/migrants could more readily explain operating a temporary help or recruitment agency specialized in hiring refugees and im/migrants than a shoe manufacturing business that employed anyone. An affordable housing organization for people with disabilities which could justify the number of market rate units it operates with reference to a feasibility study for each of its buildings might thereby demonstrate the incidental character of those units, since the number, price, and quality of units would thereby be determinable with reference to the overriding aim of increasing affordable units.

Again, the CRA already has experience applying this doctrine in the charities context which should ease its implementation in this context.[12]

2. Robust Annual Filings Ensures Transparency and Accountability to the Public

Because we are not proposing a registration system to obtain this new status, it is vital that annual filings be sufficiently detailed to enable the CRA to realistically assess the organization's purposes and the relationship of any revenue generating activities to those purposes. Furthermore, because it is the public character of these organizations' purposes which justify the special tax treatment, and there are no Provincial, Federal, or Territorial laws of general application which require a nonprofit to make basic financial information available to the public, it is relevant for such information to be collected and provided publicly under the Income Tax Act. Furthermore, because this status is voluntary and existing nonprofits could continue to benefit from s.149(1)(l), no organization would be negatively affected if they do not want to make the required information public for privacy, or whatever other reason.

The collection and public provision of certain information is further justified by the benefit to the administration and enforcement of the Income Tax Act. Enabling members of the public to access more information about an organization crowd-sources the work of holding nonprofits to account. This enforcement rationale clearly brings the collection of this information within the underlying privacy law and policy of the Income Tax Act as articulated in section 241.[13]

We propose that the contents of the return be designed in consultation with the sector.

3. An Asset Lock and Penalties for Violating Asset Lock Discourages Abuse

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[12] Leigha Haney. (2018). 'Ancillary', 'Incidental' and Canadian registered charities – Concepts and Meanings". Pemsel Case Foundation. At p.2-3. Available at: https://www.pemselfoundation.org/wp-content/uploads/2018/05/Haney-Ancillary-and-Incidental-OP-May-24-2018-pv.pdf ; Some have argued that s.149(1)(l) already allows for incidental profit-making activities. While we find these arguments compelling, we think clarity in this area by more explicit drafting would make it easier for all involved to create a more enabling environment. David P. Stevens & Faye Kravetz (2013). Current Developments in the Application of Paragraph 149(1)(l) of the Income Tax Act. *The Philanthropist*, 25(3).

[13] This section of the Income Tax Act sets out the foundational rules regarding the significant care tax officials must take in not sharing tax payer information except in specifically

The final element of our proposal is adding stronger non-distribution requirements than currently exist for nonprofits under s.149(1)(l) by adding a penalty over and above the taxes that would be owing if an organization made an inappropriate distribution. The penalty should be calculated to be the amount distributed and apply not only to the organization but also to the recipient of the nonprofit's resources who would be "joint and severally liable".

Currently, nonprofits that own real estate which significantly appreciates in value are free under the Income Tax Act to sell their assets and distribute the surplus to members. Of course, if they did so, they would cease to qualify under s.149(1)(l) and both the corporation and the members would be required to pay tax on the surplus as if the nonprofit was a business. This may be perfectly reasonable for a member benefit organization wherein members retain de facto rights to the property of the nonprofit through their governance rights to change the rules applying to the distribution of property. However, for an allegedly public benefit organization which wishes to benefit from a tax exemption for its intentionally earned surpluses, a more meaningful asset lock is required to prevent abuse.

Such an asset lock provides assurance to taxpayers, funders, members, and the government, that the public benefit organization will not benefit from its status for the purpose of accumulating income and capital only to distribute it at a time and in a manner that suits the members or directors of the organization.

Conclusion

Tax law and policy is predicated on the principle of equity between taxpayers. Like taxpayers should be treated alike and unlike taxpayers should be treated differently from each other. Public benefit nonprofits that intentionally earn a surplus to improve their financial security so they can more effectively pursue their public missions are simply not in the same position as for-profit businesses, either economically or for the purpose of government's broader policy objectives. It is a matter of fundamental tax fairness that the distinct position of public benefit nonprofits be recognized in the Income Tax Act. At the same time, ONN recognizes the need to build in robust safeguards that can be realistically enforced by the CRA. We strongly believe it is possible to do both.

Appendix A: Proposed Legislative Language

Proposed changes are highlighted.

149(1)(l.1) a non-share capital corporation, trust or association that, in the opinion of the Minister, was not a charity within the meaning assigned by subsection 149.1(1) and that was organized and operated exclusively for public benefit, any profit purpose being incidental to its stated public benefit purpose, 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

149(2) For the purposes of paragraphs 149(1)(e), 149(1)(i), 149(1)(j), 149(1)(l), and 149(1)(l.1), in computing the part, if any, of any income that was payable to or otherwise available for the personal benefit of any person or the total of any amounts that is not less than a percentage specified in any of those paragraphs of any income for a period, the amount of such income shall be deemed to be the amount thereof determined on the assumption that the amount of any taxable capital gain or allowable capital loss is nil.

149(12.1) Every person who, because of paragraph 149(1)(l.1), is exempt from tax under this Part on all or part of the person's taxable income shall, within 6 months after the end of each fiscal period of the person and without notice or demand therefor, file with the Minister an information return for the period in prescribed form and containing prescribed information.

188.1(4) A registered charity, a registered Canadian amateur athletic association, or a person exempt from tax because of 149(1)(l.1) that, at a particular time in a taxation year, confers on a person an undue benefit is liable to a penalty under this Part for the taxation year equal to

- (a) 105% of the amount of the benefit, except if the charity, association or person is liable under paragraph (b) for a penalty in respect of the benefit; or
- (b) if the Minister has, less than five years before the particular time, assessed a liability under paragraph (a) or this paragraph for a preceding taxation year of the charity, association or person and the undue benefit was conferred after that assessment, 110% of the amount of the benefit.

188.1(5.1) For the purposes of this Part, an undue benefit conferred on a person (referred to in this Part as the "beneficiary") by a person exempt from tax because of 149(1)(l.1) includes a disbursement by way of a gift or the amount of any part of the income, rights, property or resources of the person exempt from tx because of 149(1)(l.1) that is paid, payable, assigned or otherwise made available for the personal benefit of any person, as well as any benefit conferred on a beneficiary by another person, at the direction or with the consent of the charity or association, that would, if it were not conferred on the beneficiary, be an amount in respect of which the person exempt from tax because of 149(1)(l.1) would have a right, but does not include a disbursement or benefit to the extent that it is

- (a) an amount that is reasonable consideration or remuneration for property acquired by or services rendered to the person exempt from tax because of 149(1)(l.1);
- (b) a gift made, or a benefit conferred in the ordinary course of the public benefit activities carried on by the person exempt from tax because of 149(1)(l.1), unless it can reasonably be considered that the eligibility of the beneficiary for the benefit relates solely to the relationship of the beneficiary to the person exempt from tax because of 149(1)(l.1)

- (c) a gift to a qualified donee.

188.1(5.2) If a person exempt from tax because of 149(1)(l.1) confers an undue benefit on a person and it may reasonably be considered that that person acted in concert with the person exempt from tax because of 149(1)(l.1) to confer the undue benefit, that person is jointly and severally, or solidarily, liable with the person exempt from tax because of 149(1)(l.1) for the penalty imposed on the person exempt from tax because of 149(1)(l.1) under 188.1(4).