ONTARIO NONPROFIT NETWORK

The Income Tax Act: Identifying not-for-profit organizations that provide public benefit and the conditions for tax exemption

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Legislative and policy changes

In our paper, Introducing the "Public Benefit Nonprofit Sector", ONN argues that it is essential governments are able to make policy and undertake initiatives to support Canada's public benefit organizations – *charities, nonprofit cooperatives and public benefit nonprofit organizations*. In this brief, we identify the foundational legislative and policy changes needed to allow public benefit not-for-profit organizations to operate to their full potential to serve Canadians and their communities.

Canada has a complex set of rules that govern not-for-profit corporations. These rules found in the Income Tax Act (ITA) have not been substantially updated since they were first created in 1917 to support the social and recreational needs of veterans returning from the war. In the intervening 100 years, there has been substantial use of the not-for-profit corporate form by the many community and public benefit organizations that have not been eligible for charitable status. With 80,000- 100,000 nonprofit organizations across Canada, nonprofit organizations are an important component of community infrastructure.[1]

Under the ITA, these not-for-profit corporations are exempt from income tax as long as they pursue objectives that are "for any... purpose except profit". Not-for-profit organizations are identified in two main groups.[2] The first group is organizations with a member focus that currently includes private clubs, condo boards/associations, and trade and professional associations. The second group is organizations that are focused on the public good. These organizations have a public-oriented purpose, such as community sport and recreation leagues, social enterprise, or social housing.

ONN recommends four key changes to enable public benefit organizations to more effectively pursue their objectives:

1. The Income Tax Act 149(1)(l) must be amended to divide not-for-profit organizations into two classes of not-for-profit corporations: a *public benefit class* (organizations focused on the public good), and a *mutual benefit class* (organizations focused on services to members).

2.1 By creating classes for public benefit organizations and mutual benefit organizations, the CRA will be in a position to require eligibility for exemption only through a "permanent asset lock".

2.2 Policies defining "not for purpose of profit" must be amended to allow public benefit organizations to earn revenues that remain exempt from tax so long as the revenues are reinvested in the mission (referred to as a "destination test").

[1] There is not have an accurate number of all not-for-profit organizations in Canada, nor is there a good description of what they do. Estimates are about 80,000, of which ONN estimates about 85% are public benefit and 15% are member benefit.
[2] David Stevens, Faye Kravetz (2013). Current Developments in the Application of Subsection 149(1)(1) of the Income Tax Act. *The Philanthropist,* Vol 25.3 https://thephilanthropist.ca/original-pdfs/Philanthropist-25-3-534.pdf

2.3 Transparency for tax-exempt entities under the ITA should include an annual information return providing data on the organizations that is publicly available.

1. Legislative change to the Income Tax Act

There is currently no way to differentiate between public benefit nonprofits and mutual benefit nonprofits because they both fall under the same class in the ITA 149(1)(l). This means that it is not possible to make policy or provide support to either of these groups separately, even though they have different needs and operations.

In a practical way, it means there is no way to create policy or provide supports to public benefit organizations. The inability to differentiate between mutual benefit organizations and public benefit organizations means that neither have the regulation nor public support they require. This does not serve Canada well and hinders the ability to develop effective public policy and regulation for vibrant, inclusive and resilient communities. For example:

- Provincial lobbyist registration requirements cannot distinguish between industry associations and public benefit nonprofits;
- Public policy makers and the general public cannot easily distinguish between public interests and private interests in public policy debates;
- Public and private foundations can fund only charities because there is currently no way for them to legally include those nonprofits providing a public benefit in funding eligibility, while excluding member benefit nonprofits from qualifying.

Amend Income Tax Act, section 149(1)(l)

The Income Tax Act already designates classes of organizations in ITA 149(1):
(f) registered charities;
(g) registered Canadian amateur athletic associations;
(i) a corporation that was constituted exclusively for the purpose of providing low cost housing for the aged;
(i) nonprofit corporations for scientific research and experimental development.

To accomplish the goal of having two separate classes of organizations- one for public benefit and one for mutual benefit, 149(1)(l) should be split in two.

> (l) Mutual benefit organizations
> A club, society or association that is not a charity, is organized and operated primarily for the mutual benefit of its members, has no part of the income of which is payable to, or is otherwise available for the personal benefit of a member, but is applied to mutually benefit its members.

(m) Public benefit organizations

An organization, society, club or association that, is not a charity, is organized and operated primarily to benefit the public good, and is:

I. Incorporated without share capital;
II. Self-governing: there is a public goal that is advanced by the organization's activities, and none of the members benefit from a distribution of profit or surplus generated.
III. Excess revenues are reinvested: does not distribute profits to members, directors, or managers
IV. Has a constraint in its bylaws that prohibits distribution of assets to members on dissolution (provides for gifting residual assets to a public benefit organization).
V. Independent or institutionally separate from the formal structures of the federal and provincial government and the profit (corporate) sector.

2. Policy Renewal

Public benefit organizations should be enabled to deliver on their missions by removing barriers under the ITA that prevent them from undertaking their important work.

In recent years, nonprofits have been expected to become more "sustainable" by generating more earned income to reduce their reliance on government funding. The challenge is that to achieve this objective, not-for-profit organizations require revenues to meet unexpected expenses and fund or expand their activities. Current Canada Revenue Agency guidelines prohibit any "profit" (excess revenue) that is not accidental and incidental.

"Not for Purpose of Profit"

As the Canada Revenue Agency (CRA) currently interprets the Income Tax Act, nonprofit organizations are allowed to maintain their income-tax exempt status while generating income only if they do not make a profit on their activities. Any profit from an activity must be "*incidental or accidental*"[3] or it is deemed to mean the organization has a "profit purpose" and that is not allowed. In practice, this means you cannot earn revenue on one activity and use it to fund another activity. Each activity, not the organization, must break even.

[3] Stevens and Kravetz, op. cit., p. 195. [CRA Doc. No. 2011-0392841E5, supra note 26]

CRA Nonprofit Risk Identification Project

Between 2009 and 2013, the CRA undertook a Nonprofit Risk Identification Project. The final project report found a rate of non-compliance among not-for-profit organizations between 40.3% and 46.5% when measured against the current CRA interpretation of the Act.[4]

The project auditors reached the following conclusions about why the non-compliance rate was so high:

- The 149(1)(1) entity environment has evolved, including more complex and sophisticated activities and the corresponding case law (FN2) has also evolved
- Representatives of 149(1)(1) entities believe that the entities must produce a profit for the programs to thrive and for capital assets to be maintained. In a number of cases, 149(1)(1) entities wanted to expand
- The gap between the CRA and the nonprofit sector's interpretation in respect to paragraph 149(1)(1) makes the administration of this provision difficult; and
- A lack of focused compliance and education actions aimed at 149(1)(1) entity community. [5]

The CRA's current technical interpretations of the law as it relates to the tax-exempt generation of surpluses by nonprofit organizations (Income Tax Act section 149(1)(l)) do not meet what these organizations need to operate successfully in 2017. Furthermore, these interpretations are not supported by case law and historical practice since their provision was enacted in 1917. See the appendix for legal cases that support changing the current narrow definition held by the CRA.

ONN appreciates that the CRA is attempting to control and prevent misuse of the tax exemption provision under 149(1)(1) by using a very narrow interpretation of "not-for-purpose of profit". However, the results of the audit indicate this approach is not working. Prohibiting organizations from earning revenue in one part of the organization and using the funds to support other non-revenue producing activities has forced almost 50% of organizations audited to be non-compliant. The organizations themselves reported they would not be able to comply and continue to operate and achieve their missions.

There is great concern among nonprofit organizations about their vulnerability to having their tax-exempt status challenged by the CRA. The consequences are severe. For example, social housing providers found with reserves at levels deemed excessive by CRA but required by provincial legislation would face tax implications that would close their organizations. Too many public benefit nonprofit organizations are forced to choose between complying with CRA regulation and running a sustainable, responsive organization. It is an impossible choice.

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[4] The Non-Profit Organization Risk Identification Project (NPORIP) Report was prepared by the Specialty Audit Division of the Small and Medium Enterprises Directorate. It provides the NPORIP results used to evaluate the risk associated with entities claiming an exemption under paragraph 149(1)(1) of the Income Tax Act (the "Act").

[5] Canada Revenue Agency (2013). *Non-Profit Organization Risk Identification Project Final Report.* Copy on Canadian Charity Law. https://www.canadiancharitylaw.ca/blog/the_non_profit_organization_risk_identification_project_nporip_report_final

The CRA's regulatory interpretation is also creating a disincentive for individuals who may want to start a not-for-profit social enterprise but are increasingly likely to use the for-profit corporate form instead because of the strict revenue rules. This trend has implications for community wellbeing and Canadian social institutions. If innovative responses to social challenges are being established almost exclusively in the form of for-profit corporations, the benefits of these innovations- jobs, social capital, and organizational assets- will accrue to the private individuals who own these corporations, rather than to communities.

> Neither not-for-profit organizations nor the Government of Canada are being adequately served by the existing guidance. Moreover, Canadian communities are denied an appropriate, public-oriented corporate structure for growing social, and recreational infrastructure.

Recommendation 2.1
Exempt only organizations that are legally bound to keep their assets in the public domain in perpetuity from income tax

By creating classes for public benefit organizations and mutual benefit organizations as recommended, the CRA will be in a position to require that eligibility for the income tax exemption is achieved by adopting a "permanent asset lock". An asset lock is a robust legal clause that requires an organization's income and assets to be applied solely to further the purposes of that organization (which may not include the pursuit of benefit or gain for its members), and ensures that none of its net earnings is used or applied for private gain by its members. An asset lock ensures that the activities of the nonprofit organization are always focused on the pursuit of social or benevolent objects, and that its assets remain in the public domain, never distributed to members. A robust and permanent asset lock will also avoid the need for a regulator. This option should be required for public benefit organizations and available on a voluntary basis for mutual benefit nonprofits if they commit to the asset lock.

Recommendation 2.2
Permit a "destination test" for public benefit organizations

This approach will enable the CRA to adhere to the legal precedent established by the courts by adopting, in its policies, a "destination test" for business revenue of public benefit organizations.

This would clarify that it is acceptable to operate revenue-generating activities, provided any surplus from those activities is applied for "*benefit with a public character*". There is a clear advantage of having a public benefit nonprofit operate a social enterprise, instead of a for profit organization. A public benefit nonprofit supports the accumulation of community assets, as opposed to growing personal wealth.[6] These community assets will grow in time and will be increasingly important for community health.

In comparison, the destination test does not work for mutual benefit nonprofits (opting for an asset lock) that deliver benefits to their members. They would require a mutual benefit test. Their purpose is to provide services to members at cost, rather than at market value, without generating profits for an outside owner.

Distribution of surplus in mutual benefit nonprofits can, and does happen by reducing fees if a surplus is generated. Essentially, members of this kind of nonprofit pool their resources to provide a public benefit they could otherwise only access through a market-priced business.

Member benefit nonprofits are already operating under this system. The CRA has agreed that as long as it is only members who benefit, the exemption from tax is permitted. However, if non-member revenue (e.g. rental of party rooms, etc.) is generated in a material amount, reducing the members' fees as a result, it should be taxed. Otherwise it would be avoiding tax on business income indirectly.

This would not constrain mutual benefit nonprofits from raising money from its members, or providing services to its members, provided the compensation for use of that money, or the cost to the member for those services, does not exceed market value.

Recommendation 2.3
Increase the transparency of public benefit nonprofits falling under ITA 149(1)(l)

The federal government should require all incorporated nonprofits exempt from tax to file and make public their annual financial data and a description of their activities. With increased transparency, public benefit nonprofits can demonstrate that their revenues are supporting the public good, while making it easier to identify those organizations that are not adhering to fair tax regulations.

[6] For more on social enterprises, see ONN's Policy Blueprint for Social Enterprise (2014). http://theonn.ca/wp-content/uploads/2014/"/ONN-Policy-Blueprint-for-Social-Enterprise.pdf
[1] Charities are eligible for exemption from tax under other legislation.

Conclusion

It is long past time to update the legislation and regulation of not-for-profit organizations. This brief has identified the changes to the Income Tax Act required by the public benefit nonprofit sector to undertake its important work in communities. The current tax regime is seriously constraining the development of a robust social economy, which will have a direct impact on the health and vitality of communities. It it time to act on a renewed regulatory environment for these organizations to better serve and support Canadians, and communities.

This is the second in a series of policy papers addressing the need to renew the legislative and regulatory frameworks affecting public benefit organizations, the vital organizations serving our communities and the people in them.

Read: Introducing the "Public Benefit Nonprofit Sector"

What do you think?

We want to hear from you! Share your feedback:

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For more information, visit:

http://theonn.ca/our-work/our-regulatory-environment

Appendix

To qualify as an NPO exempt from tax under ITA 149(1)(l) an organization must be organized and operated exclusively for social welfare, civic improvement, pleasure or recreation or for any other purposes except profit.
There are four key requirements under paragraph 149(1)(l):

(1) The entity claiming the exemption must not, in the opinion of the Minister, be a charity under subsection 149.1(1).[7]

(2) The entity must be a "club, society or association."

(3) The entity must be "organized and operated exclusively for social welfare, civic improvement pleasure or recreation or any other purposes except[CM8] profit."

(4) No part of the income of the entity can be payable or available for the "personal benefit of any proprietor, member or shareholder."

From the CRA income tax interpretation bulletin IT496R

The issue in the courts

The CRA has attempted several times to curtail commercial activities by nonprofits, alleging that the accumulation of surplus, or profit, implies a purpose of *pursuit of profit*.

The federal courts, however, have taken a more liberal view of nonprofits' commercial activities. In the two leading cases, Gull Bay, and Canadian Bar Insurance Association, the courts refused to uphold the CRA's findings, holding, in the 1984 Gull Bay[8] decision, that:

> The social and welfare activities of Plaintiff are not a cloak to avoid payment of taxation on a commercial enterprise but are the real objectives of the Corporation.
>
> ... The Corporation is operated "exclusively" for the purpose set out in Section 149(1)(l) pursuant to its charter, even though it may raise funds for this purpose by its commercial lumbering enterprise.

[7] Charities are eligible for exemption from tax under other legislation.
[8] Gull Bay Development Corp. v. The Queen, 84 DTC 6040, 1984.
https://thephilanthropist.ca/original-pdfs/Philanthropist-4-2-597.pdf

In the 1999 Canadian Bar Insurance Association decision, the court held that:

> Because the Appellant's preponderant purpose was the availability of certain insurance products at cost, it did not have a profit purpose at all. …
>
> The large reserves do not reflect a profit purpose but a service to members purpose. A person (individual or corporate) with a profit purpose will usually want to use any profit as some method of personal gain by the payment of dividends or salaries or by the increased value of issued shares. The Appellant did not use the stabilization reserves in any of those ways.
>
> In my opinion, the Appellant was neither organized nor operated for a profit purpose."[9]

Neither case was appealed by the CRA. They remain good law in Canada.

Notwithstanding the courts' binding decisions, the CRA has in fact redoubled its efforts to constrain nonprofits' tax-exempt commercial activities. The CRA did not revise its Interpretation Bulletin IT496R in light of the court rulings, and in recent years, the Agency has adopted a stricter interpretation of the permitted scope of nonprofits' tax-exempt activities.

As David Stevens, a prominent lawyer in the not-for-profit and charities field, writes,

> "The current approach by CRA to the *Income Tax Act (ITA) paragraph 149(1)(l)* is spelled out in several technical interpretations that appear to narrow the circumstances in which CRA will consider an entity to be "organized and operated exclusively for social welfare, civic improvement …or any other purposes except profit."[10]

The CRA's recent interpretations mean that nonprofits are operating under regulations with which, in many instances, it is impossible to comply while successfully running their organizations.

In the social housing field, for example, provincial regulations require social housing providers to maintain sufficient reserves for housing maintenance but this puts the nonprofits at risk of the CRA finding these provincially mandated reserves to be excessive.

[9] Canadian Bar Insurance Association v. The Queen, 1999 CanLII 463 (TCC). http://www.canlii.org/en/ca/tcc/doc/1999/1999canlii463/1999canlii463.html
[10] Stevens and Kravetz, op. cit., p. 159

The situation that the CRA has created is illustrated by this recent CRA ruling letter:[11]

> … if a material part of the excess is accumulated each year and the balance of accumulated excess at any time is greater than the association's reasonable needs to carry on its non-profit activities, profit may be considered to be one of the purposes for which the association was operated.
>
> You have asked whether the use of surplus funds to create academic scholarships for students at the universities and colleges where XXXXX of the members are XXXXX is an indication of a profit purpose.
>
> It is our view that where an organization has an accumulated surplus that is large enough to fund academic scholarships this could indicate that the organization may have retained earnings larger than is necessary to meet its not-for-profit objectives and therefore that organization may not be operating exclusively for a purpose other than profit.
>
> However, a review of all of the circumstances, including (but not limited to) how and why the surplus was accumulated and the length of time over which the surplus has been accumulated may indicate that the Organization does not have a profit purpose, notwithstanding the surplus. In addition, generally surpluses may not be viewed as reflecting a for-profit motive if the entity is taking reasonable business steps to reduce the surpluses e.g., by adjusting the costing of its products or services.

[11] CRA Views 2015-0565601E5, Acceptable uses of accumulated surplus by an NPO, August 31, 2015.

ABOUT ONN

Organized in 2007 and incorporated as a nonprofit in 2014, the Ontario Nonprofit Network (ONN) is the convening network for the approximately 55,000 nonprofit and charitable organizations across Ontario. As a 7,000-strong provincial network, with a volunteer base of 300 sector leaders, ONN brings the diverse voices of the sector to government, funders and the business sector to create and influence systemic change. ONN activates its volunteer base and the network to develop and analyze policy, and work on strategic issues through its working groups, engagement of nonprofits and charities and government.

OUR VISION

A Strong and Resilient Nonprofit Sector. Thriving Communities. A Dynamic Province.

OUR MISSION

To engage, advocate, and lead with—and for—nonprofit and charitable organizations that work for the public benefit in Ontario.

OUR VALUES

Courage to take risks and do things differently. **Diversity** of perspectives, creativity and expertise to get stuff done. **Optimism** and **determination**. **Solutions** created by the sector, with the sector, for the sector. **Celebrating** our successes and **learning** from our experiences. **Strength** that comes from working **together**.

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