Time for a Review: Registered Charities and the Income Tax Act

This article has been adapted from a keynote address to the Canadian Bar Association symposium on charity law, held in Toronto on May 12, 2017.

Many people have heard of the Rosetta Stone. The Rosetta Stone is so named because it was uncovered in the Egyptian town of Rosetta in 1799 by French soldiers of Napoleon Bonaparte's army when he invaded Egypt. If you look closely at it, it has a text in Egyptian hieroglyphs at the top, a text in Egyptian demotic in the middle, and at the bottom, a corresponding text in Greek.[1]

The reason the three texts are present is that the stone was carved during the reign of the Ptolemaic pharaohs. The Ptolemaic dynasty of pharaohs was Greek, not Egyptian. Ptolemy I was a general of Alexander the Great and he inherited the throne of Egypt on Alexander's death in 323 BCE. The court of the Ptolemaic pharaohs was Greek, not Egyptian, and the language of the court was Greek. Cleopatra was Greek, not Egyptian.

In Egyptology, the interest of the Rosetta Stone lies in the fact that it helped cryptographers crack the code of Egyptian hieroglyphs whose meaning had been lost over the centuries. Jean-François Champollion, in particular, established a correspondence between the Greek text, and cartouches in the hieroglyphic text which he surmised contained the names of gods and pharaohs. This summarizes what is common knowledge about the Rosetta Stone.

What is little known about the Rosetta Stone is that it talks about tax exemption. The text is called the Decree of Memphis, and it refers to an agreement between Pharaoh Ptolemy V, and the priesthood and the temples of Egypt. Pharaoh granted tax exemption to the priests and temples on the condition that the priests agree to set up statues of pharaoh in each of the temples, to allow Egyptians to venerate pharaoh as a living god. This was an astute attempt by the Ptolemies, as foreign rulers, to legitimize their rule and have it accepted by the Egyptian population at large.

Now you may wonder what I'm getting at with all of this. In the context of the current symposium, my point is that in a few centuries, we've progressed from a tax-exemption provision that no one could read, to a tax-exemption provision that no one can understand. I'm referring of course to section 149.1 of the *Income Tax Act*, which regulates registered charities.

My contention is that the central problem with the rules in the Act as they relate to charities, and one of the reasons why charities face challenges in complying, lies in the inconsistent drafting of s. 149.1. In particular, 149.1 is peppered with the notion of "activities," not always in a consistent manner, and the provision's inconsistency has consequences in its interpretation and in the Canada Revenue Agency's (CRA's) administrative policies that flow from the legislation.

I'm hoping that I can provide you with a better understanding of how s. 149.1 works – or perhaps more precisely how parts of it don't quite work, so that in your individual practice you

are better able to address the issues that this raises.

But I need to make a disclaimer before I start: although I was in policy work for most of my career, I am happily retired; the views I express are my own, and they don't represent the views of the government, the Agency or the Department of Finance.

The thoughts I'm about to present to you find their source in a policy approach I first formulated last year at a Max Bell Foundation conference in Calgary whose topic was charities' involvement in political activities. They're also consistent in several respects with recommendations found in the recent report by the Consultation Panel commissioned by the Minister of National Revenue, on the political activities of charities.[2]

Of the more than 86,000 charities that are currently registered under the Income Tax Act, more than 75,000 are charitable organizations.[3] The Income Tax Act apparently defines a charitable organization in subsection 149.1(1) as ". . . an organization, whether or not incorporated, (a) all the resources of which are devoted to charitable activities carried on by the organization itself . . . "

On reading this text for the first time, your reaction may have been the same as mine: if a charitable organization can only spend resources on charitable activities, how can it also cover the costs of fundraising for instance? Especially since the CRA expressly distinguishes the two.

Notably, 149.1 also distinguishes between expenses on administration on the one hand, and charitable activities on the other – which suggests that the so-called definition on the preceding slide doesn't jibe with reality. There's an apparent conflict between the alleged definition for registration purposes and the requirements set out in other parts of the same provision.

Elsewhere, 149.1 distinguishes between "political activities" and "charitable activities." Now, admittedly, if those political activities fall within the expenditure limits specified in subsection (6.2), they're considered charitable for the purposes of the Act. But at least initially, there is a conceptual difference between charitable activities and those that are political.

Another interesting distinction arises between charitable activities and the notion of related or unrelated business. The definition of related business in 149.1 is rather laconic.[4] But it's at least clear that if a registered charity is involved in unacceptable business activities, it exposes itself to penalties or loss of registered status. And the CRA's policy clearly distinguishes between a charitable activity even if it functions for instance on a fee-for-service basis, and the purportedly different concept of a "related business."

If we look at fundraising activities, the CRA policy on fundraising specifically states: "Fundraising is not a charitable purpose in itself or a charitable activity that directly furthers a charitable purpose."[5]

Interestingly, fundraising isn't mentioned specifically in section 149.1, perhaps out of concern for some potential constitutional issues. The CRA policy on fundraising is an outgrowth of the disbursement quota brought into the legislation in 1976 whose objective at the time – according to the accompanying budget documents – was in effect to control fundraising costs and to draw a distinction between charitable activities and fundraising or other activities. Eventually, the disbursement quota was deemed unhelpful and too onerous, and it was reduced to a shadow of

its former self in the mid-2000s. But the distinction between fundraising activities and charitable activities subsists, supported by the omnipresent references to “activities” in 149.1.

Finally, the T3010 information return that all registered charities must file annually, confirms and perpetuates the need to differentiate a charity’s “charitable” activities, from its “other” activities.

Although the CRA has softened its stance on stand-alone activities in recent years, it still has an inordinate focus on activities, charitable or otherwise – a focus which manifests itself in the widespread use of the term in administrative policies, both separately and often conflated with the notion of purposes.

This reflects the Agency’s own struggle with the notion of activities, and with the wording of the Act. The CRA should be bound by the Act and the letter of the law, but right now, the inconsistencies are such that the CRA can be seen as striking out on its own.

The focus on different kinds of activities causes a number of problems for you and the organizations that you represent, not only when an organization applies to be registered, but also when it tries to account for its expenditures either via the annual information returns or as a result of an audit.

Tracking the resulting allocation of expenditures often calls for subjective interpretation – your guess or the CRA’s. The need to devote a charity’s staff to this kind of work detracts from the real work that charities should be doing; it hinders the efficiency of Canadian charities that conduct their operations abroad; it intimidates those charities that believe they need to speak out on the public square; and it inhibits charities that want to explore innovative ways of addressing social problems.

The challenge of course is to draw the line between charitable activities and all other kinds of activities. Sometimes these concepts are mutually exclusive. But often, they overlap. A business activity can also be a fundraising activity. A charitable activity can bring in revenue, just like a fundraising activity. A speech that contains an account of a charity’s programs can also include an appeal for donations and a request that people call their MPs. How are we supposed to monetize these activities? Should we put a stopwatch on the person speaking, or count the number of tainted words or paragraphs? Is it fair to paint everything as fundraising, or as political, including the upstream research? How do we quantify what happens on social media? If actually distributing food to poor families is charitable, what about collecting and packing the foodstuffs? Or negotiating a lease and renting the premises to store donated food? Or recruiting and training the staff? Or meeting to discuss the range of operations or selection criteria for beneficiaries?

Where do the charitable activities end, and the other activities begin? Whether an organization falls on the right or the wrong side depends on how thickly or how thinly one slices the activities sausage. And too often that depends on the one holding the knife.

Take the case of *Williams Trustees*.[6] This is a 1947 English case that denied an organization’s charitable status essentially because its purpose was to function as a social club for people of Welsh descent living in London.

I don't have a problem with that. But take this case and apply it at the level of a discrete activity, say for an organization whose purpose is to help integrate refugees into the local community. The organization might provide used clothing and furniture, English second-language courses, and so on. Say the organization also proposes to hold weekly get-togethers at which refugee families meet some of their own as well as members of the community at large. The CRA has been known to take *Williams Trustees*, apply it at the activity level, and either deny the application for registration, or compel the organization to drop that aspect of its programs altogether. And it claims it's entitled to do so by the law.

This isn't uncommon. The CRA sometimes does this also with organizations whose relief programs have an entertainment component, a sports component, a referral service to other resources in the community, and so on.

On the Agency's side the focus on activities causes problems too: the policies the CRA rolls out, and that tend to focus on activities, need to achieve a level of granularity that can provide enough guidance to CRA staff, and to potential charities, on the range of activities any organization could reasonably undertake. Also, the policies continually conflate the notions of "activities" and "purposes," further clouding the issue.

This produces sometimes abstruse outcomes as in the case of *Canadian Magen David Adom v. M.N.R.,***[7]** where the purchase of a telecommunication system for an ambulance service was considered acceptable, but the purchase of a personnel identification system for the same service – for security and record-keeping purposes – was not, leading to the revocation of the organization.

The courts haven't hesitated to express their bewilderment on the wording of s. 149.1. The Supreme Court of Canada characterized the focus on activities as a "major problem." Still, as far as the common law is concerned, the Court seems to have put the matter to rest. In *Vancouver Society of Immigrant and Visible Minority Women v. M.N.R.*,[8] Iacobucci stated for the majority

"The difficulty is that the character of an activity is at best ambiguous; for example, writing a letter to solicit donations for a dance school might well be considered charitable *(oddly enough, this is in direct contradiction to the CRA position on fundraising)*, but the very same activity might lose its charitable character if the donations were to go to a group disseminating hate literature. In other words, it is really the purpose in furtherance of which an activity is carried out, and not the character of the activity itself, that determines whether or not it is of a charitable nature."

That's fine, but this judicial interpretation runs headlong into the wording of s. 149.1 that distinguishes different kinds of activities and requires charities and the Agency to somehow parse them out. Even if one case referred to the matter as "an area crying out for clarification through legislation," judicial comment hasn't yet moved government to fix the problem.

Now, there's a reason for this mess. And in order to understand it, we have to perform some "legislative archaeology," and get our fingers dirty.

The current overall structure of s. 149.1 goes back to 1976. That's as far as Justice Marceau went in *Scarborough Legal Services***[9]** when he was trying to figure out the notion of activities

in the context of the Act. He should have dug deeper. The definition of a charitable organization goes back much further – to the 1950s.

I don't want to take this discussion too much into the weeds, because there was some tweaking of the wording over the years, and some shuttling from one section to the other, so I'll use a version in the 1964 legislation – which I chose purely at random, and which at that time referred to s. 62 (1) of the Act,[10] but all the relevant provisions are more or less the same prior to 1976.

In the 1950s and 60s all the way up to 1976, there were three kinds of charities: charitable organizations, charitable non-profit corporations, and charitable trusts.

The wording used in addressing the concept of a charitable organization in 1964 was

62(1)(e) A "charitable organization" is an organization whether or not incorporated, all the resources of which were devoted to charitable activities carried on by the organization itself (...).

You'll note that it is substantially the same as we find after 1976 and as we have today: ". . . all the resources of which are devoted to charitable activities carried on by the organization itself." (There's a slight change in the tense of the verb – from the past tense to the present – but otherwise the provisions then and now are identical.)

But what's more interesting are the companion descriptions for the other kinds of charities found in paragraphs (f) and (g) of the same subsection. Significantly, the definitions of charitable non-profits and charitable trusts also include the wording "charitable activities carried on by the organization itself."[11]

What's also interesting is that, in contrast to the definition of a charitable organization, paragraphs (f) and (g) also include a provision allowing trusts and charitable non-profits to move funds to other charities, generally in a one-way direction, toward charitable organizations. Charitable organizations on the other hand, if you read the provisions as a whole, couldn't transfer funds to other charities – they had to use the funds for their own programs.

The general structure of this wording suggests that the provisions here were simply intended – not as a qualifier for registration -- but as a descriptor of how different categories of charity were expected to move funds around. It doesn't suggest an additional activities test different from the purposive approach used in common law.

In 1976, the *Income Tax Act*'s overall regulatory structure for charities changes: charitable trusts and charitable non-profits are replaced as categories of registered charities, by two somewhat different classes of charities, namely public foundations and private foundations.

But what's significant in all of this is that the expression for charitable organizations – "all the resources of which are devoted to charitable activities carried on by the organization itself" – remains essentially the same. And throughout these changes as well as before them, the official explanations for the categories remains absolutely consistent: the Carter Commission Report in 1967,[12] as well as the Discussion Paper that precedes the 1976 changes,[13] and the Budget Paper that accompanies these changes,[14] always explain the categories as a distinction between the "funders" of charity, and the "doers" of charity – the majority of the sector, the charitable organizations. There is never any official mention, in connection with the legislation,

of a test for activities to be applied in isolation.

Somehow, after 1976, and arguably independently from the Act, the Department of National Revenue starts viewing the reference to a charitable organization as justifying an activities test – perhaps buoyed by the disbursement quota which kicks in in 1977, and which attempts to control fundraising expenses notably by requiring charitable organizations to spend 80% of their receipted donations on “charitable activities.”

Consequently, at that time, and as a result, if you assumed that the wording established a stand-alone activities test, a charity couldn’t be involved even in the slightest bit in behaviour that was “political.” So between 1976 and 1985, which is when the current rules on political activity were introduced, the Department was routinely refusing to register organizations that were involved in any amount of activity that was considered political. The 1985 amendment introducing the rules on political activities was in fact permissive, not restrictive, and was intended to correct what was perceived as an unfortunate wording of the Act. Unfortunately, it also introduced its own set of slippery policy slopes that were difficult if not impossible to assess objectively, as the recent Report to Minister Lebouthillier points out.

The same goes for charities involved in foreign activities – instead of illustrating a difference between funders and doers, the rider “carried on by the organization itself” was now interpreted as requiring a charity to have stringent direction and control over its activities abroad, going well beyond the common-law concept of agency, and causing all kinds of administrative problems and paperwork. [15]

Interestingly, since after 1976, the wording for charitable foundations no longer contained the wording “carried on by the organization itself,” this raised the possibility that foundations could circumvent the new policies on “direction and control.” This apparent flaw in drafting wasn’t corrected until many years later, after a clever charity lawyer discovered the loophole, and set up a foundation that sent funds abroad without complying with the letter of the CRA’s policy on “direction and control.” When CRA found this out in the late 1990s, it pressured the Department of Finance to amend the Act and require that foundations restrict their transfers to qualified donees only – essentially other Canadian charities.

In light of all this, what we have today, as a result of this focus on activities, is essentially an accretion of patchwork amendments and administrative policies that only increase confusion and complexity, that conflate purposes and activities, that contain all kinds of slippery slopes, that are not consistent with themselves, not consistent with the common law, and that open up all kinds of interpretation issues.

Logically, an activities test should only be justified when it is used at common law to ascertain the existence of real or unstated organizational purposes. Admittedly, we can argue about exactly when an activity becomes a primary purpose, and this is going to turn on a number of facts such as context, amount of ongoing attention, relative level of expenditures, logical connection to the organization’s other purposes, the organization’s overall messaging, any partnerships it has with other organizations, the settlors’ stated intent, and so on. But such a test on activities should still be viewed only to determine an organization’s true overall purposes.

Even if we accept this, we’re still left with a conflict between the wording of the Act and the

common law, and we're still left with legislation and policies that require us to parse out charitable activities from other kinds of activities.

One solution to bring the Act into the 21st century might be to refocus its provisions toward the purposive approach of the common law: define charities in the Act in light of the common-law purposes for which they're set up, and eliminate the requirement to draw impervious barriers between different kinds of activities. Unfortunately, so far, the current government approach, it seems, is to prefer a review of administrative policies rather than questioning the soundness of 149.1's legislative footing. It places the cart before the horse. It overlooks the fact that bad law makes for bad administrative policy.

The activities distinctions are artificial and arbitrary; their overlaps often make them unworkable; charities need more flexibility, not less, if they are to meet current societal challenges. And in particular, as we've seen recently, there are looming policy arguments in favour of loosening some of the restrictions on charities' political activities. If Canada believes in democracy and in an informed electorate, charities should not be excluded from the marketplace of ideas. If they are, society suffers.

Using a purposive approach, political activities for instance, would be acceptable, to the extent that they remain ancillary and incidental to a higher charitable purpose. This would eliminate the need to track and report in detail on such activities.

The same goes for fundraising activities or administrative activities. Any questions of fundraising abuse or misappropriation of funds can be addressed through the concept of undue private benefit, already present in the statute.

Finally, a purposive approach might signal to the courts that it is time for them to reassert their responsibility for making the definition of charity evolve rather than deferring to the will of Parliament as expressed in the *Income Tax Act*.

Refocusing the rules on the purposive approach of the common law is a potential solution that has received a fair amount of interest in the charitable sector in the past year. A purposive approach facilitates charitable action rather than controlling it. It addresses several existing problems. It would ensure better harmony between the Act and the common law, and also provide some underlying consistency to the income tax provisions.

Admittedly it also introduces some gray zones – but that may be what's needed. The CRA loves bright lines. Bright lines are good for determining the amount of taxes you owe. But they're ill-suited to determining whether an organization qualifies as a charity at common law. In the latter context, bright lines are inflexible, and result in the hide-bound application of administrative policies.

I'm afraid though that some people look at the purposive approach as a panacea, a cure-all – it may appear relatively simple in that it essentially involves eliminating references to "activities" in 149.1 and replacing them with references to "purposes," where required. But this approach will not solve all income-tax issues with which the sector is wrestling. At best, it deals with some problems and it provides a unifying foundation on which further progress can be made. We all have to recognize that there are some areas where the fisc is genuinely concerned, and where there is a legitimate need for targeted provisions.

In particular, there would likely have to be a provision preventing partisan political activity. Otherwise, charities could be used – especially by large and powerful financial interests – to circumvent election financing rules. Still, involvement in partisan politics needs to be better defined than at present. The notion of electioneering used in the United States for instance, is far easier to understand and pin down.

Business involvement is another area. Even if, at common law, charities can't engage in profit-making enterprises directly, government will want to address the potential for charities to compete unfairly from a tax-exempt position, against tax-paying businesses. However, any regulation of charities' business involvement should specify what kinds of activities charities can't undertake, rather than leaving the matter open-ended and ill-defined as it is now, and it would need to allow for hybrid ventures like social financing and social enterprise.

On Canadian charities that operate outside Canada, I recognize there is a legitimate need to prevent Canadian charities from channeling funds abroad to less savoury activities. But the "direction and control" rules directly impact Canadian charities' ability to engage in effective partnerships, and they are arguably *ultra vires*. They affect project funding; they affect the management of resources; and they affect the perceptions and the principles of international humanitarian aid. It is difficult if not impossible to conciliate the existing rules with accepted best practices in the international arena and with the notion of equitable partnerships. Current international approaches to foreign aid favour integrated operations among all actors, as well as localized action. We might consider, for instance, a more flexible regulatory structure such as the notion of expenditure responsibility used in the United States. And the direction and control issue also touches many charities that operate in Canada through intermediaries, such as United Ways, community foundations, and community arts councils.

Disbursement rules might still be needed to prevent charities from parking funds indefinitely. And at the same time, the anachronistic classification of charities into charitable organizations, and public and private foundations, might be replaced by a risk-based approach that recognizes the greater risk of abuse associated with all closed charities that aren't open to community scrutiny, not just private foundations.

Litigation also needs to find a more balanced route than the current appeal process to the Federal Court of Appeal. Right now, to all practical extents, the prospect of a favourable outcome in an appeal hearing is very remote, and courts are reluctant to intervene to make the definition of charity evolve because the Act's language is too intrusive and has made too many inroads into the common law. In fact, the recent Report to the Minister of Revenue on Political Activities also mentions the need to revise the appeal process.

I think government is at a crossroads where it needs to recalibrate the balance between two competing legal ideologies: the taxing statute and the jurisprudential approach of the common law.

A purposive approach obviously isn't the only option to solving current problems with the Act's provisions. It is to me, a politically viable step forward, it addresses some foundational issues, and it opens the door to addressing others. But regardless of which approach we take, at the very least, it has been more than 40 years since the overall structure of s. 149.1 has been reviewed. Sound legislative practice usually incorporates a regular review process to fix problems and ensure that the law addresses issues in a contemporary way.

Section 149.1 was enacted at a time that may have been more naïve, when charities relied on bingos, car-washes and the occasional bequest, and when the act of charity was more top-down and paternalistic. Today, charities operate in an environment that increasingly addresses problems systemically, that is increasingly trans-border, hybrid, commercialized, professionalized, and shaped by new technologies.[16] Charities and volunteers can be forgiven for having difficulty understanding the current provisions. The real tragedy is if public servants refuse to address the problems with the legislation. Surely it is time for a review.

[1] The stone is currently on display in the British Museum.

[2] http://www.cra-arc.gc.ca/chrts-gvng/chrts/cmmnctn/pltcl-ctvts/pnlrprt-eng.html

[3] https://twitter.com/CanRevAgency/status/818544166997200896/photo/1

[4] See s. 149.1(1) of the Act.

[5] *Fundraising by registered charities,* CRA policy guidance CG-013

[6] *Williams Trustees v. Inland Revenue Commissioners*, (1947) A.C. 447.

[7] *Canadian Magen David Adom for Israel v. Canada (Minister of National Revenue),* 2002 F.C.A. 323.

[8] (1999) 1 S.C.R. 10.

[9] *Re Scarborough Legal Services and the Queen*, 17 D.L.R. (4d) 308, at p. 320.

[10] 1952 R.S.C. c. 48.

[11] Note that in 1964, the wording in paragraph (g) is slightly different, but it was subsequently amended to match the wording found in (e) and (f).

[12] *Report of the Royal Commission on Taxation*, 1967, Queen's Printer, volume 4, pp. 128 and ff., at p. 131

[13] *The Tax Treatment of Charities,* Department of Finance, June 23, 1975.

[14] *Charities Under the Income Tax Act,* Department of Finance, Budget Paper D – Charities Under the Income Tax Act, May 25, 1976.

[15] *Canadian registered charities carrying out activities outside Canada,* CRA policy guidance CG-002

[16] https://carleton.ca/sppa/wp-content/uploads/April-28-Philanthro-Think-program.pdf