Related Business: What's Okay and What's Not*

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The issue of business activities undertaken by registered charities has become critical in Canada, as in other countries. As government funding to nonprofits has been significantly reduced, many organizations are turning to commercial activities to try to replace that revenue. This in turn has caused a backlash as private sector businesses complain to the Canada Revenue Agency about "improper" activities by the non-taxable sector.

There is a good argument that this is not an area that should be the subject of reform. The rules actually have worked quite well and most of the complaints about "unfair" competition by charities are not well founded. For example, we simply cannot sympathize with commercial health clubs that attack the YMCA organizations, given that the commercial organizations chose to enter a field where the Y had operated for more than a century.

We also have grave doubts about the notion of competition being unfair. We are not aware of any situations where charities use their tax-exempt status to undercut commercial operations on pricing.[1] Indeed, the only case where charities have made a major commercial impact to the detriment of commercial organizations has been in the production and selling of greeting cards. The commercial groups have survived by doing production for the charities!

Thus, we have grave doubts as to the wisdom of re-opening the debate about the business activities of charities. But the genie seems to be out of the bottle and the issue is one that we will have to live with.

The Statutory Framework

From the time the *Income Tax Act* was significantly amended to set out explicit rules applicable to the tax treatment of charities, the issue of business activities has been dealt with through provisions in the *Act*. Charitable organizations[2] and public foundations[3] are allowed to carry on "related business activities." Private foundations are precluded from carrying on any business activities. The penalty for a breach of the rule is potential deregistration as a charity.

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The term "related business activity" has never been defined. Indeed, when the legislation was first drafted, a close look was taken at the American experience and, as a result of an assessment of the complexities of that system, which involved taxing unrelated business profits, it was decided to keep the Canadian legislation silent on the subject.[4]

It is important to note that Canada's approach differs considerably from that of other countries. Generally in other countries, income from unrelated business activities is taxed, while income from related business activities is tax exempt. Thus, in practical terms, charities in many foreign countries can carry on unrelated business activities by paying tax like a commercial organization. In the United Kingdom, however, a destination test is applied and so long as the profits go toward an organization's charitable purposes, no tax is imposed and there are no functional limitations on what a charity can do by way of business activity.[5]

The Canadian approach does not allow for taxation of charity income. This means that the only penalty for carrying on an unrelated business activity is deregistration, which in turn means that a charity that runs afoul of the law will be forced to divest itself of all its assets. This approach means, of course, that the need to keep "onside" is perhaps more crucial in Canada than it is in most other countries.

The decision not to define related business activities may have been wise when one considers the possible activities that the term might imply, especially when measured against the charity's objects. When one considers a university, for example, we see that everything from selling books and tickets for cultural and sporting events, to offering computer time, meals, and accommodation may be viewed as "related" activities.[6]

But there is a second string to the rules that is important to thousands of charities. The definition provisions of section 149.1 state that:

> "related business", in relation to a charity, includes a business that is unrelated to the objects of the charity if substantially all persons employed by the charity in the carrying on of that business are not remunerated for that employment."

This provision was designed to exempt from the related business test such things as the provision of lobster dinners by churches in Prince Edward Island, the running of bingos and the holding of bazaars, the sale of greeting cards and the operation of *Paper Things*, an undoubted business run by the National Ballet of Canada from a shop on Yorkville Avenue in Toronto.

The CRA applies the 90% rule to the "substantially all" test and there have been no challenges that we are aware of volunteer business activity under the *Income Tax Act*.[7]

The Case Law

The carefully, if vaguely, drafted legislation was rendered a virtual nullity by the first case in which Revenue Canada challenged the activities of a charity. The case was *Alberta Institute on Mental Retardation v. The Queen*.[8] The organization in question was a fundraiser for several other charities. It had an undoubtedly commercial business arrangement with a private sector company that generated substantial income that ultimately went to charitable purposes. The organization requested to be itself registered as a charity but was turned down on the grounds that it was carrying on "unrelated business activities."

In a two-to-one decision, the Federal Court of Appeal told Revenue Canada to register the organization. Speaking for the majority, Mr. Justice Heald said in part:

> "Turning now to the submission that the appellant is carrying on a business as defined in subsection 248(1) of the Act because of its commercial involvement with Value Village, I do not think that the association of a charitable organization with a commercial enterprise necessarily impresses that charitable organization with the characteristics of a 'business' within the definition set out in subsection 248(1), supra. Where, as in this case, the involvement of the charitable organization with a commercial enterprise is not an end or purpose in itself but is merely a means to the fulfillment of the purposes of the charitable organization which are exclusively charitable, that involvement will not result in the charitable organization losing its exemption."

And later:

> "For these reasons I have concluded that, in the somewhat unusual circumstances here present where all of the moneys received are dedicated to the charitable purposes for which the appellant was incorporated and where the business aspect of the operation is merely incidental to the attainment of its charitable objects, the appellant can, indeed, be said to be operating exclusively for charitable purposes."

Revenue Canada asked for leave to appeal this decision to the Supreme Court of Canada, but leave was refused.

To put none-too-fine a point on it, this decision completely changed the Canadian law.[9] It effectively adopted what is known in the charity community as the "destination test,"[10] suggesting that so long as business activities generate income that is used for the charitable purposes of the organization, the activities are *de facto* related.

Another judicial challenge arose in 2002 in the case of *Earth Fund v. The Queen*.[11] This case involved what would (had it been registered) have been a public foundation with what we might call "ordinary" foundation objects. What made it unusual is that it planned to raise substantial revenues through the

running of an international Internet lottery. It would carry on no other activities save to transfer profits to qualified donees in Canada.

It was rejected for registration on the grounds that the running of the lottery would be an "unrelated business." The appellant relied primarily on the decision in the Alberta Institute case.

In upholding the refusal to register, Madame Justice Sharlow, speaking for a unanimous panel had this to say:

> "Justice Heald, writing for the majority, rejected the Minister's argument. He held that the charitable objects of Alberta Institute were being fulfilled because all of the proceeds from the collection of used goods were given to appropriate charities. He also held that even if the collection of used goods could be said to be a business, it would be a 'related business' because of the close connection between the activity and the charitable objects of Alberta Institute, and because the funds raised by the activity were entirely dedicated to those charitable objects.
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> I do not accept the argument of counsel for the appellant that the Alberta Institute case is authority for the proposition that any business is a 'related business' of a charitable foundation if all of the profits of the business are dedicated to the foundation's charitable objects. The Minister in that case was arguing that Alberta Institute was 'a wholesaler of goods,' but in fact Alberta Institute was simply soliciting donations of goods which it converted to money. This is somewhat different from the traditional fundraising activities of a foundation, but the difference is only a matter of degree.
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> By contrast, the appellant proposes to do nothing except market and sell lottery tickets in a manifestly commercial arrangement that will, if all goes as planned, result in a profit that will be donated, I assume, to qualified donees. The appellant is in exactly the same position as any commercial enterprise that commits itself to apply its profits to charitable causes. Such a commitment, by itself, does not derogate from the commercial nature of the activity that generates the profit. Given the particular facts of this case, the Minister was justified in concluding that the appellant's proposed lottery operation would be a business of the appellant that is not a 'related business,' and thus would not qualify as a charitable activity."

The decision is extremely unhelpful in that it seems to reject the destination test without overturning the Alberta Institute decision. It offers not an iota of clarification as to what the term "related business" means, leaving us with the guidance offered by Alberta Institute, which has effectively been gutted. In addition, the Court closed its eyes to the fact that a very large number of foundations in Canada have as their sole fundraising activity the running of one or two lotteries a year. The court also refused to comment on the fact that Revenue Canada (as it then was) consistently registers charities which appear to exist only to run bingos and casinos.

These facts were brought to the Court's attention, but it was not intellectually honest enough to admit that its decision was functionally useless in terms of clarifying the law.

The Charity Directorate Guidelines

Soon after the decision in Earth Fund, the Charities Directorate of CRA (as it now is) issued a policy statement that attempted to clarify its interpretation of the law as it applies to "related business." The first thing that must be pointed out is that this policy statement does not represent "the law" but only the current CRA interpretation. Neither the administration nor the courts are bound by these guidelines. (The policy statement, entitled "What is a Related Business?" is available on the CRA website at <www.cra-arc.gc.ca/tax/charities/policy/cps/cps-019-e.html>.)

The policy statement is a useful explication of the views of the CRA but actually offers no substantive guidance. It has some useful examples but in fact often simply states the obvious. It says, for example, that the mere fact that fees are charged does not *ipso facto* mean that the charity is carrying on a business.[12] We'd think that in a world where running a university or hospital is considered to be a charitable activity, that observation is pretty much redundant.

In paragraph 5, it says that soliciting donations is not a business because it is not "commercial." The same paragraph states that the reselling of donated goods is not a business, neatly getting around the problem posed by the decision in the Alberta Institute case. We would have to say that the rationale (because the charity depends on donations for its inventory) is hardly persuasive, although the conclusion is welcome. Indeed, any other position on the resale of donated items would have created a political firestorm.

One of the most useful discussions, because the issue is raised so often, relates to the exploitation of unused capacity by a charity.[13] The policy statement adopts the common sense position that is best summed up by paragraph 28, which states:

> "In the above examples, the charity acquired the asset in question because it was needed in its charitable programs and because it made economic sense to acquire the asset rather than to lease it. These conditions need to be met for the business use of the asset to be considered a related business."

The policy statement, however, dodges some of the hardest question by being silent. The complete absence of comment about any aspects of fundraising through gambling (bingos, casino nights, and lotteries) betrays a complete lack of willingness by the CRA to deal with thorny questions, reflecting the same unwillingness to be helpful as characterized the Federal Court Appeal in the Earth Fund decision.

If a charity decides to get involved in raising funds through gambling, the paper offers no guidance unless the operation is substantially run by volunteers.[14] This is a huge gap in the paper, given the enormous amount of money raised by charities in Canada through gambling activities.

Most organizations and their advisers will ultimately look to the "decision tree" which is produced at the end of the paper to try to work out whether a particular activity is in fact a related business activity. It offers a handy dandy set of rules, but when push comes to shove, those using it must make their own decisions about whether a particular activity qualifies.

One more observation might be useful.

We have seen a couple of audits since the paper came out in which the focus was on whether the organization was carrying on a related business activity. In no case did the auditor cite the policy statement in the report that went to the Charities Directorate. Nor was there any evidence that the auditors[15] were aware of the statement or applied any of its guidelines.

In a nutshell, the policy statement gives a decent outline of the obvious elements of the law and not much else. It presumably contains guidelines to which the Charities Directorate will adhere…if the individuals in question know what they are and if they are in the mood.

The statement has some use, of course, but it is no substitute for law. We have to rely on it because the Courts are unwilling to fulfill the role of explicator of the law and because Parliament (or more accurately, the Department of Finance) doesn't want to touch the issue.

In the end, the issue of what is meant by "related business" remains as murky as it was the day the original legislation was published back in 1975.

While it is beyond the purview of this article, we would note that charity advisers have been quite adept in finding ways for charities to carry on commercial activities that are clearly and by any test non-related. The two main approaches are the use of a controlled corporation to carry on the activity or the use of a business trust. A fairly high level of planning sophistication is needed to properly implement either of these alternatives, but hundreds of organizations have been using these substitute vehicles for extended periods of time and with some high level of satisfaction.

NOTES

1. Is parking cheaper in downtown Toronto at a parking lot run by a hospital than at a commercial lot? Are book prices lower at university bookstores than at commercial stores?
2. ITA paragraph 149.1 (6) (a).
3. ITA paragraph 149.1 (3) (a).

4. Author's memory. It was decided to issue a brochure with the new legislation to give examples of what was related business activity, which included a shop in an art gallery and a cafeteria in a hospital.
5. This is why one notices so many "charity shops" on the "high streets" of England.
6. The American approach, on the other hand, makes the gift shop in an art gallery distinguish between the sales of postcards of works in the gallery's collection (related) and post cards of works in other collections (unrelated).
7. The test has been looked at on a number of occasions vis à vis the issue of GST and charities, though insofar as we are aware, there has been no case law on the subject. It is important to note that the 90% rule is not "absolute" and the courts, in different contexts, have said that this is simply an approximation. Thus, if an organization used only 87% volunteers, it is our view that it would not run afoul of the "substantially all" test.
8. [1987]2C.T.C.70; 87 D.T.C.5306.
9. The Court cited with approval our book *Canadian Taxation of Charities and Donations*. This is a case of mixed emotion…pleased at the citation and wondering how the comments in the book could have been so misinterpreted.
10. Insofar as we are aware, only New Zealand formally uses a "destination" test.
11. [2003] 2 CTC 10.
12. Paragraphs 6 and 7.
13. See paragraphs 26-29.
14. One of the reasons the "volunteer" exception was put in place was to allow churches to continue to run bingo operations. Of course, over the years, the problem of getting the needed volunteers has become more and more of a problem.
15. Most of the auditors come from Consulting and Audit Canada and thus almost certainly do not have the knowledge necessary to conduct an audit on a charity.

New Editorial Board Member

The Philanthropist is pleased to announce that **Peter Broder**, Corporate Counsel and Director, Regulatory Affairs at Imagine Canada, has joined the Editorial Board. Peter edited Industry Canada's *Primer for Directors of Not-for-Profit Corporations* (2002) and has written extensively on policy and regulatory issues related to charities and nonprofit organizations. He holds an LL.B. from the University of Ottawa, and is also a graduate of both Concordia University (Communication Studies) and the University of Toronto (Bachelor of Arts).