Charities and the Federal Income Tax Provisions: Getting and Staying Registered

PEARL E. SCHUSHEIM
Member, The Ontario Bar

It is trite to say that most Canadian taxpayers regard the federal income tax laws as a necessary evil. This attitude may be found to be somewhat more pronounced, however, among Canadian registered charities.

While the *Income Tax Act (Canada),* R.S.C. 1952, c.148, as amended (the *Act*) provides substantial benefits to registered charities and their donors, it imposes significant requirements on charities for both initial registration and continuing qualification. It must be remembered that the provisions of the *Act* affecting charities are not intended to raise revenue for the government. They are intended, rather, to facilitate charitable activities and to encourage charitable donations. To these ends, registered charities are accorded tax-exempt status and donors are allowed limited tax deductibility for their charitable donations. These provisions, however, may have an unintended opposite effect for the unwary and unsophisticated charity that is ill-equipped to comprehend and manage their complexity.

The previous article, prepared by the Charitable and Non-Profit Section of Revenue Canada Taxation sets out the essential elements that the Registrations Branch looks for before it approves an application by a charity for registered status.[1] This article, therefore, will not describe comprehensively the formal application and registration process but will attempt to highlight and clarify, in a non-technical manner, selected provisions of the *Act* that are relevant to the initial and continuing registration requirements.

A. Application Process

1. Who Can Apply?

The reasons for applying for registered status are obvious. As previously mentioned, a charity which qualifies for registration will enjoy tax-exempt status under the *Act*[2] and will be able to issue tax receipts for the donations it receives.[3]

In order to obtain registered status, however, the applicant must be considered charitable under the principles of common law, i.e., it must further one or more of the following charitable purposes: relief of poverty, advancement of education, advancement of religion or other charitable purpose beneficial to the community. The last category is the broadest and most difficult to define, given the absence of a statutory definition, and is intended to embrace an evolving concept of charity. Although an extensive discussion of the common-law concept of charity is beyond the scope of this paper, it is crucial for an

applicant to satisfy the common-law test before proceeding to apply for registered status.

2. Classification

Having decided to seek registered status and having determined that its objects are charitable at common law, the applicant charity must then consider the appropriate category under which to apply for registration.

The definition of "registered charity" now effectively requires each applicant to apply for registration specifically as a charitable organization, private foundation, or public foundation.[4] Under the old definition of "registered charity", it was not necessary for the applicant to so target its application. It was sufficient merely for the applicant to qualify, initially and at any time after registration, under any one of the three stated categories. Therefore, in one year a registered charity might have been considered an active charitable organization while, in another year, the same registered charity might have qualified as a public foundation due, for example, to a dramatic increase in its level of funding to other qualified donees and a corresponding decline in its level of charitable activities.

The significance of the more rigid distinctions now made among types of registered charities is found in the differing disbursement quotas, certain anti-avoidance provisions aimed specifically at foundations and the requirements regarding non-qualified investments, applicable only to private foundations.

(a) *Charitable Organization*

The charitable organization is commonly considered the "doer". The essential elements of the definition of "charitable organization" require that all its resources be devoted to charitable activities it carries on; that no income be made available for the personal benefit of its members; that it have an arm's-length board of directors; and that not more than 50 per cent of its capital be derived from a single funding source.[5]

(i) Activities

Although a charitable organization must carry on charitable activities, there is no requirement in the *Act* that these activities be carried on in Canada and, in fact, they may be carried on anywhere in the world. Accordingly, a charity that intends to carry out its charitable activities in a developing country need not be deterred from applying for registered status.

Furthermore, the charitable activities to which a charitable organization must devote all its resources need not be carried on directly by the charitable organization but may be carried on indirectly through agents. This position is recognized and supported by Revenue Canada Taxation in paragraphs 18 and 19 of *Information Circular 80-10R.*

(ii) No Income to Members

According to the practice established by Revenue Canada Taxation, the prohibition against making income available for the personal benefit of its members does not prevent a charitable organization from paying reasonable salaries or honoraria to its members. Further, such prohibition should not, for example, prevent a church from allowing its members to use a hall for functions.

(iii) Arm's-Length Directors and Funding

The arm's-length-directors test and the broadly based funding requirement are intended simply to ensure that the charitable organization is not a privately controlled entity.

(iv) Objects

The statutory definition of "charitable organization" imposes only an activity test and does not refer to a purpose or objects test. Revenue Canada Taxation, nevertheless, will require the charitable organization to satisfy an exclusively-charitable-objects test. Although the statutory basis for applying an objects test to a charitable organization may be questionable, in view of the fact that the definition of "charitable organization" in the *Act* does not refer to objects or purposes, it is prudent for an applicant seeking registration as a charitable organization to ensure that it meets this requirement. Accordingly, the applicant should not word its objects so broadly as to permit non-charitable activities.

(b) *Charitable Foundation*

The charitable foundation is commonly considered the "giver". The definition of "charitable foundation" sets out a two-fold test which requires that the foundation be both constituted and operated exclusively for charitable purposes. Further, no income may be made available for the personal benefit of foundation members and it must not be considered a charitable organization.[6] The "charitable foundation" category is subdivided into public and private foundations.

(i) Public Foundation

In addition to the tests set out for charitable foundations in general, a public foundation must have an arm's-length board of directors and a broad funding base.[7] These are the same tests that apply to a charitable organization.

(ii) Private Foundation[8]

The private foundation classification is a residual category that will apply to registered charities which fail to meet the tests for a charitable organization or public foundaton. Thus, if a public foundation fails to have an arm's-length board of directors or a

sufficiently broad funding base, it should apply for registration as a private foundation.

It is evident, from a review of the definitions of charitable organization, public foundation and private foundation, that the essential distinctions are between the doer and the giver and between the public and the private entity. An applicant that intends to be a doer should apply for registration as a charitable organization but it must ensure that is satisfies the public aspects of that definition. An applicant that intends to be a giver should seek to satisfy the definition of public foundation or, failing that, apply for registration as a private foundation.

(c) *Change in Classification*

A registered charity is not bound to remain in the category under which it initially acquires registration. It is quite possible that a registered charity's circumstances may change so that its original classification is no longer appropriate. In that event, the charity may apply to the Minister of National Revenue (the "Minister") to be redesignated in the appropriate category.[9] Although such a formal application to the Minister for a change in designation must be made using one of the prescribed forms,[10] a registered charity should first approach the Registrations Branch informally to effect the desired change. Thus, if a charitable foundation, whether public or private, wishes to cease being a "giver" and to become a "doer", it may apply to the Minister to be designated as a "charitable organization" provided that it satisfies all of the requirements in the definitions of that term.

A change in designation may also be initiated by the Minister if, after reviewing the circumstances of a particular registered charity, he considers that its registered category is no longer appropriate to those circumstances.[11]

As this designation provision is quite new, it is not yet clear under what circumstances the Minister might consent to an application for, or intitiate a change in, designation.

A formal appeal procedure is available if the registered charity does not agree with the Minister's change of designation or if the Minister refuses a registered charity's application for a change of designation.[12] Such an appeal would be made to the Federal Court of Appeal.

3. Objects and Activities

As stated earlier, the objects of a registered charity must be capable of being included in at least one of the four common-law charitable categories and the wording of these objects must not permit non-charitable activities. Certain non-charitable activities, however, are permitted. For example, administrative and fund-raising activities are implicitly permitted while limited ancillary

non-partisan political activities[13] and "related business" activities[14] are explicitly allowed.

In engaging in these non-charitable activities, a registered charity must be careful not to exceed the permissible scope for expenditures on such activities. A charitable organization does not appear to be limited in the extent to which it may devote its resources to a related business.[15] In order to engage in non-partisan political activities, however, charitable foundations and organizations must first satisfy a "substantially all" test[16], i.e., substantially all of their resources must be devoted to charitable activities. This test would appear, therefore, to limit non-partisan political activities to about 10 per cent of resources as "substantially all" is generally interpreted to mean approximately 90 per cent (see Section 6). Activities which are purely administrative or related to fund raising and not directly related to charitable activities, would have to be financed with funds remaining after the disbursement quota had been satisfied.

B. Continuing Requirements

1. Disbursement Quota

(a) *General*

In order to maintain its registered status, a registered charity must spend a certain minimum amount each year on charitable activities or on gifts to qualified donees. This amount is known as the "disbursement quota".[17]

The calculation of the disbursement quota differs for each category of registered charity. It is simplest for charitable organizations and most onerous for private foundations. In very general terms, the disbursement quota may be described as follows:

(i) All registered charities must spend at least 80 per cent of the receipted donations received in the immediately preceding year (subject to certain exclusions) on their charitable purposes. This is the only test applicable to charitable organizations;

(ii) In addition, all charitable foundations must disburse 4.5 per cent of the prescribed value of assets not used in charitable activities;

(iii) Public foundations must disburse 80 per cent of gifts received from other charities in the immediately preceding year; and

(iv) Private foundations must disburse 100 per cent of gifts received from other charities in the immediately preceding year.

Charitable organizations, therefore, are subject only to the 80-per-cent of-receipted-donations test and need not be concerned with the 4.5-per-cent test or gifts received from other charities.

(b) *Exclusions*

Recent amendments to the *Act* provide a number of important exclusions from the calculation of the disbursement quota. These exclusions are relevant in calculating the 80-per-cent test and, therefore, are applicable to all registered charities. The exclusions may be summarized as follows:

(i) gifts of capital received by bequest or inheritance;

(ii) 10-year "directed" gifts; and

(iii) gifts from other registered charities.[18]

The first two exclusions are intended to assist registered charities in establishing endowment funds and pools of capital from which they may derive additional income for working capital and reserve purposes.

The first exclusion generally applies to lump sum gifts of capital made by a testator by means of a will. Prior to the recent amendments to the *Act*, a charitable organization that issued a receipt for such a gift would be required to spend 80 per cent of it in the following year and, similarly, had no ability to exclude endowments from the 80-per-cent test. As the exclusion for endowments, discussed below, has now effectively been extended to charitable organizations, it was also necessary to exclude gifts of capital made by will because, unless the recipient charity is aware of a donor's intention to make a gift by will prior to the donor's death, it would not be possible to go back to the donor and ask that the gift be worded as an endowment (i.e., that the donor direct the registered charity to retain the principal amount for at least 10 years and spend only the income earned thereon). This exclusion ensures that lump-sum bequests and inheritances can be treated in the same way as endowments and need not be disbursed in the year following their receipt. Consequently, registered charities will not be penalized by their inability to control the wording by which a gift is made through a will.

The second exclusion applies to endowment-type gifts where the donor has stipulated that the principal be held by the recipient charity for at least 10 years. This rule is analogous to the old exclusion which, effectively, was only relevant in the calculation of a charitable foundation's disbursement quota.

These first two exclusions are especially important for charitable organizations which, prior to the recent amendments, had no ability to establish endowment funds from receipted donations. If a receipt was issued, the charitable organization was required to disburse 80 per cent of the receipted amount in the following year. These new exceptions,

therefore, should greatly assist a charitable organization in funding its own activities.

The third exclusion applies to gifts received from other registered charities for which receipts are issued. Although a charitable donation receipt is unnecessary for and, in fact, useless to a donor that is a registered charity or other tax-exempt entity, donation receipts are often inadvertently issued to other registered charities. This exclusion ensures that inter-charity gifts for which receipts are issued are not included in a charitable organization's calculation of its disbursement quota. Public and private foundations, however, will be required to consider inter-charity gifts in calculating their disbursement quotas whether or not receipts are issued for those gifts.

It is important to note that the 80-per-cent aspect of the disbursement quota implicitly provides an additional exclusion for non-receipted sources of funds. Some typical examples of non-receipted donations are: government grants, church collection-plate donations and income earned from bake sales, daffodil sales, and similar activities. (Non-receipted gifts from other registered charities are also excluded from the 80-per-cent test but are included under another aspect of the disbursement quota applicable only to charitable foundations.) This non-receipted revenue, however, is subject to the global requirements that the charitable organization devote all its resources to charitable activities and the charitable foundation operate exclusively for charitable purposes.

(c) *Relieving Provisions*

If a registered charity fails to meet its disbursement quota in any given year, it risks losing its registered status.[19] A registered charity may avoid this harsh result, however, by relying upon certain relieving provisions in the *Act*.

(i) Reduction by Ministerial Discretion

A registered charity which finds that is is unable to meet its disbursement quota in a particular year may apply to the Minister for a reduction of the disbursement quota for that year.[20] Under this new provision, if the Minister agrees to such a reduction, the registered charity will be deemed to have expended the deficiency on charitable activities. As failure to meet the disbursement quota may be a common problem, it will be interesting to watch the circumstances in which the Minister will grant a reduction.

This provision replaces the previous averaging mechanism which was quite complex and, consequently, infrequently used. Despite its complexity, the old averaging mechanism was based on objective

criteria whereas the new reduction mechanism depends upon a discretionary decision of the Minister.

A registered charity would apply for a reduction of its disbursement quota if it failed to meet, or anticipated that it would be unable to satisfy, its disbursement quota due, for example, to an unsuccessful fund-raising campaign or excessive start-up costs. However, an application for such relief should only be made if there is no other remedy available under any other provision of the *Act*. It would be necessary, for example, to first determine if there was any remaining disbursement excess from the five preceding taxation years or the subsequent taxation year to apply to a disbursement quota deficiency in the year in question.

A registered charity would also apply for this type of relief it if were unable to find appropriate activities to undertake or donees to fund and, therefore, could not make its required charitable disbursements in a responsible manner within the requisite time limits.

All applications for relief must be made using the prescribed form.[21]

(ii) Carry-Over of Disbursement Excess

The disbursement quota establishes only a minimum level of charitable disbursements. Accordingly, a registered charity is not prevented from exceeding its disbursement quota in any given year. So as not to discourage a registered charity from exceeding its disbursement quota, the *Act* allows it to carry any resulting "disbursement excess" forward five years or back one year.[22]

This carry-over mechanism effectively prevents the Minister from revoking the registration of a registered charity that has failed to meet its disbursement quota until that charity has had an opportunity to create a disbursement excess in the following year. Similarly, the Minister cannot disregard the charity's disbursement record for the five immediately preceding taxation years. It is important to note that it is no longer necessary for a registered charity to obtain the approval of the Minister in order to create a disbursement excess.

(d) *Anti-Avoidance Rules*

The *Act* sets out a number of rules which are intended to ensure that tax-exempt funds are ultimately spent on charitable activities and to prevent foundations from avoiding the 4.5-per-cent disbursement test.[23] It is sufficient, for the purposes of this article, to simply point out the existence of these anti-avoidance rules. They should not present any traps for the unwary as they are not intended to apply unless an intention to

reduce the disbursement quota or delay charitable expenditures is found to exist.

In addition to the explicit anti-avoidance rules, another form of anti-avoidance provision can be found in the related requirements that a charity be registered in a fixed category and that a change of category may only be achieved by Ministerial designation. The rigid classification rules effectively prevent charities from changing their activities or disbursement patterns in order to "flip flop" between charitable categories in an attempt to achieve the most favourable disbursement-quota calculation.

(e) *Specified Gifts*

It is generally agreed that it is important that charitable resources be allocated to those areas where they are most needed and can be put to the best use. Accordingly, the *Act* allows registered charities to pass property freely among themselves after they have satisfied their disbursement quotas for the year.

Having satisfied its disbursement quota, a registered charity may make a "specified gift" to another charity.[24] That specified gift will not be included in the recipient's base for calculating its disbursement quota and will not be considered an expenditure on account of the donor's disbursement quota.[25] Such specified gifts will not be considered to be gifts from other charities for the purpose of calculating a foundation's disbursement quota. [26]

2. Income

The significance of the concept of "income" has been considerably diminished by recent amendments to the *Act*. Although that concept is no longer relevant to the calculation of the disbursement quota, it remains important in attaining and maintaining registered status.

The basic definitions of "charitable foundation" and "charitable organization" prohibit such entities from making income available for the personal benefit of their members. The concept of income is also still relevant in determining whether a charitable organization is devoting its resources to charitable activities. A charitable organization may make disbursements to qualified donees and still be considered to be devoting its resources to charitable activities provided that such disbursements to qualified donees do not exceed 50 per cent of the charitable organization's income.[27] Finally, income may be relevant in determining whether a charitable organization or public foundation has satisfied the broadly based funding rule which requires that not more than 50 per cent of the organization's capital be contributed from one source. The meaning of "capital" in this context is not clear but should exclude income in the year in which it is earned.

3. Non-Qualified Investments

An important new concept introduced by recent amendments to the *Act* concerns non-arm's-length or "non-qualified investments."[28] This concept is applicable only to the relatively small number of charities that are registered as private foundations. "Non-qualified investments" replaces the old concept of "qualified investments" and requires private foundations to achieve a minimum return on such investments.[29] Failure to achieve this required minimum return will result in a tax imposed upon, and payable by, the issuer of the non-qualified investment.[30] The provisions of the *Act* dealing with non-qualified investments are quite complex and, as they should affect very few registered charities, they will not be discussed at length in this paper. Suffice it to say that all private foundations should be aware of these provisions and of the duty of trustees in general with respect to the investment of trust funds.

4. Related Business

The *Act* allows charitable organizations and public foundations to carry on related businesses.[31] Private foundations may not carry on any business.[32] A "related business" implicitly includes any business that is related to the objects of the charity. It is also defined to include a business that is unrelated to a charity's objects if substantially all of the employees of such business are not remunerated for such employment.[33]

It is important to note that, in order to satisfy this definition, the employees may not be remunerated by anyone. It will not be sufficient if the employees are not remunerated by the charity carrying on the related business. Technically, therefore, it will not be possible for a charitable organization or a public foundation to make use of the employees of a donor if such employees are paid by the donor for their employment in the related business. As a practical matter, however, it may be sufficient to demonstrate that the remuneration paid to such employees did not relate to the services provided to the related business.

5. Control of a Corporation

Public and private foundations are not permitted to acquire control of any corporation.[34] For this purpose, "control" means control of more than 50 per cent of a corporation's issued voting share capital.[35] However, a charitable foundation need not, in all circumstances, fear acquiring control of a corporation by way of gift.

Under the old rules, a foundation would not be considered to have acquired control of a corporation if it had not acquired, for consideration, any of the shares of that corporation. If, for example, a foundation had purchased only one share of a corporation and subsequently had been given control of that corporation, it would have been deemed to have acquired control of that corporation. As a result of recent amendments to the *Act*, charitable foundations now have a five-per-cent threshold.[36] In other words, charitable foundations will not be deemed to have acquired control of a corporation if they have not

acquired, for consideration, more than five per cent of the issued shares of the subject corporation.

6. Political Activities

As indicated earlier, registered charities are now permitted to carry on limited non-partisan political activities provided that such activities are incidental and ancillary to their charitable purposes and activities. As a result, it is anticipated that certain activities which were once of concern to Revenue Canada Taxation will no longer be of concern and that registered charities will be permitted to carry on, in good conscience, certain types of ancillary political activities, such as lobbying or making submissions to the government for legislative change related to their charitable objects.

The exact scope of such permissible non-partisan ancillary political activities remains unclear and has been the subject of extensive controversy in the past. Clarification by Revenue Canada Taxation is necessary in the form of either an *Information Circular* or *Interpretation Bulletin.*[37] Although such a publication is expected, until it is released, registered charities or applicants that wish to carry on ancillary non-partisan political activities might consider obtaining an informal interpretation from the Registrations Branch or a formal advance income-tax ruling from the Rulings Directorate of Revenue Canada Taxation. If the Minister determined that the proposed or actual activities were partisan or more than ancillary and incidental or that the "substantially-all" test had not been met, the consequence for carrying on such activities might be deregistration of an existing registered charity or refusal to register an applicant.

Conclusion

The foregoing discussion reviews selected provisions of the *Act* with which most registered charities should be familiar. It is important, however, for registered charities and applicants who are seeking registered status not only to become familiar with all the relevant provisions of the *Act* but also to approach both the *Act* and Revenue Canada Taxation without any adversarial bias. The continuing vitality of the charitable sector requires that all concerned remain co-operative as they pursue their common objectives.

FOOTNOTES

1. Reference should be made to the following Revenue Canada Taxation publications and provisions of the *Income Tax Act* (Canada) and *Regulations*:

   (a) *Information Circular* 80-10.

   (b) *Interpretation Bulletins*:

   110R2—Deductible Gifts and Official Donation Receipts;

   110R—Annuities Purchased from Charitable Organizations;

226—Gift of Residual Interest to a Charity;

244R—Gifts of Life Insurance Policies to a Charitable Organization;

288—Gifts of Tangible Capital Properties to Charity and Others;

297R—Gifts in Kind to Charity and Others; and

407R2—Disposition of Canadian Cultural Property.

(c) *Forms*:

T2050—Application for Registration; and

T3010—Public Information and Information Return.

(d) *Income Tax (Canada)*:

Paragraphs 110(1)(a), (b), (b.1), (8)(c), and 149(1)(f);

Subsections 110(1.2), (2), (2.1), (2.2), (2.3), (3), (4), (5), (8.1), and (8.2);

Sections 149.1, 150, 168, 172, 180, 188 and 189.

(e) Income Tax Regulations: Parts XXXV and LVIII.

2. Paragraph 149(1)(f).
3. Paragraph 110(1)(a); Regulation 3500.
4. Paragraph 110(8)(c).
5. Paragraph 149.1(1)(b).
6. Paragraph 149.1(1)(a).
7. Paragraph 149.1(1)(g).
8. Paragraph 149.1(1)(f).
9. Subsection 110(8.2).
10. Forms T636A, T637B and T638C.
11. Subsection 110(8.2).
12. Subsection 172(3).
13. Subsections 149.1(6.1) and (6.2).
14. Paragraphs 149.1(2)(a), (3)(a) and (6)(a).
15. Subsection 149.1(6).
16. Subsections 149.1(6.1) and (6.2).
17. Paragraphs 149.1(1)(e), (2)(b), (3)(b) and (4)(b).
18. Clauses 149.1(1)(e)(i)(A), (B) and (C).
19. Paragraphs 149.1(2)(b), (3)(b) and (4)(b).
20. Subsection 149.1(5).
21. Form T-2094.

22. Subsections 149.1(20) and (21).

23. Subsections 149.1(4.1), 188(3), (4) and (5).

24. Paragraph 149.1(1)(k).

25. Subsection 149.1(1.1).

26. Subparagraphs 149.1(1)(e)(ii) and (iii).

27. Paragraph 149.1(6)(b).

28. Paragraph 149.1(1)(e.1). Excluded from the definition of "non-qualified investments" is any share listed on a prescribed stock exchange (i.e., a stock exchange prescribed by the Income Tax Regulations) either in or *outside* Canada. Formerly only stock exchanges inside Canada were prescribed for the purposes of the definition of "qualified investments". See *Income Tax Regulations:* Part XXXII, Sections 3200 and 3201.

29. Section 189.

30. *Ibid.*

31. Paragraphs 149.1(2)(a) and (3)(a).

32. Paragraph 149.1(4)(a).

33. Paragraph 149.1(1)(j).

34. Paragraphs 149.1(3)(c) and (4)(c).

35. Paragraph 149.1(12)(a).

36. *Ibid.*

37. A publication setting out Revenue Canada Taxation's views on this subject is being prepared but has not, at the time of writing, been released to the public. Revenue Canada Taxation has indicated that copies of the final publication will be sent to all registered charities.