Some Major Issues Affecting Evaluation of the Charities Tax Incentive*

CARL D. JUNEAU
Chief of the Technical Interpretations and Communications Section, Charities Division, Revenue Canada, Taxation

In 1967 when the requirement to register for income tax purposes first came into effect, the Department was dealing with a much smaller and less complex charitable sector. Most applicants were "mainstream" charities—churches, schools, hospitals, relief organizations—and "charity" was still defined in the traditional way as "good works".

While historically charities have been at the forefront of social reform, the sophisticated kind of charitable activism now evident in all areas of Canadian social policy was then in its infancy and there was not the same "big business" atmosphere we often see now. With tough competition for increasingly scarce public and private sources of funding, charities have had to become more innovative and aggressive in their search for funds. Many have felt it necessary to turn to commercial endeavours or professional fund raisers.

This transition has meant significant changes in the profile of organizations applying for registration. Statistically, for example, although religious organizations still account for approximately 47 per cent of existing registered charities, they now represent less than 26 per cent of new applications. Social welfare, educational, and community-benefit groups now account for more than two-thirds of new applications.

One of the results is that we now must deal with a greater number of more difficult, controversial, and contentious applications. Occasionally, of course, we do have fringe groups applying, or cases where noncharitable intentions are masked in a bid to obtain that all-important ability to issue receipts, or even to obtain some of the ancillary benefits registration provides, such as eligibility for provincial sales tax rebates. But more often we are looking at organizations committed to addressing the underlying causes of poverty and other social issues as

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an essential part of their relief efforts, thus blurring the line between political activism and charity.

Another result is the growing need to examine whether, in today's world, the policy aims of the charities tax measures are being well served by the existing legislative controls on business activities and other less traditional fund-raising methods.

Our Minister has initiated a review of the administration of the charities tax incentive. The review takes a good hard look at a number of areas where the Department is trying to make improvements in its administration of the *Income Tax Act*. This article will address two issues of particular interest to the legal community. The first is the distinction between the "advancement of education", an acceptable charitable purpose, and "political advocacy", which is not recognized as charitable, and the other is the problem of what constitutes a "related" business. It will also outline a proposal which would, I believe, make it possible for the Department and the legal profession to work more closely together to make the registration process less confusing and contentious.

The *Income Tax Act* provisions relating to charity are administered on the basis that the adjective "charitable" bears its common-law meaning. Common law determined that purposes that qualified as "charitable" should be capable of existing in perpetuity as a trust, and to do so they must be beneficial to the community within certain criteria. In determining whether or not a purpose was charitable in the context of trust law, the courts were usually deciding whether there was sufficient public benefit to permit the trust to operate for an unlimited duration. The consequences of holding the trust *not* to be charitable were usually that the trust failed and the settlor's wishes were frustrated. In that case, the funds would often pass to distant relatives. In view of this, it is not surprising that the courts have often pushed analogies to the limit in order to accommodate the wishes of the deceased settlor. The result has been a body of law of considerable complexity.

It would be inaccurate to characterize the actions of the Department as simply following the common law and going no further. In an area where purposes and means to achieve them are continually evolving, the common-law case approach provides the Department with guidance in determining whether a new purpose is charitable. Analogy is a flexible mechanism, and in general the Department has not taken a restrictive view of the requirement for analogy, and has not felt constrained to deny registration where a reasonable analogy can be drawn between the purposes at hand and those previously held to be charitable.

Nevertheless, it is clear that the complexity of the judicial concept of charity leads to a lack of transparency in the registration process. It is difficult for applicants to understand why the Department accepts some purposes as charitable and others not. This, in my view, is an important administrative challenge, one which offers an opportunity for the legal community to play a positive role.

Education and Advocacy

One of the most difficult problems the Department continues to encounter in registering charities is the necessity of distinguishing between education and advocacy. Today, this is probably the area where the public perception of education differs most from the legal concept. Consequently, many advocacy groups—convinced of the rightness of their causes—apply for registration confidently stating their aims as being to educate the public on a particular issue. They are then astonished to discover that the Department does not necessarily consider their purposes to be charitable.

For us, the question "Where does education leave off and political advocacy begin?" is not merely academic. It is one we must wrestle with daily. We must take the facts of a particular situation and attempt to reason out how the courts would view the matter.

This task has been made somewhat easier in the past few years because we now have the benefit of recent Federal Court decisions on appeals against the Department's refusal to register three organizations actively involved in social issues. These decisions (*Positive Action Against Pornography* v. *Minister of National Revenue*, 88 D.T.C. 6186, *Toronto Volgograd Committee* v. *Minister of National Revenue*, 88 D.T.C. 6192, and *N.D.G. Neighbourhood Association* v. *Revenue Canada, Taxation Department*, 88 D.T.C. 6279) dealt with the boundaries of charitable purposes as they relate, in particular, to groups formed to advocate one side of a particular social issue; to promote international understanding; and to act as advocates on behalf of a specific group within the community.

I think it would be useful to examine one of these decisions in some depth as an illustration of the factors the courts have taken into consideration in distinguishing "education" from "political advocacy".

Positive Action Against Pornography, an organization incorporated under the *Alberta Societies Act*, applied for registration in October, 1985. The organization's primary purpose as identified in the information submitted was "to develop and distribute educational material concerning the issue of pornography". The reason the Department gave for

refusing the application were set out in the judgment. The Department took the position (on page 6188) that "... the imparting of knowledge contemplated by the applicant is inextricably mixed with persuasion to such an extent that it is a noneducational activity". It went on to say that it viewed the organization's various activities as being intended "... to sway public opinion in support of minimizing and possibly eliminating pornography from our society...", and that although it was not suggested that the organization, itself, was agitating for a change in legislation affecting the issue of pornography, an organization "... need not go that far to be categorized as political in nature...". It added "...(i)t is not enough that the approach employed by an organization is by way of discussion, workshops and information to the public; the purpose to which such activities are directed must be clearly and exclusively charitable if the organization is to qualify...".

In delivering the decision of the Court, Stone J. appeared to endorse this distinction, for he said (at page 6189):

> ...I am quite unable to find in the record before us anything pointing to "advancement of education" in its legal sense, for neither formal training of the mind nor the improvement of a useful branch of human knowledge is here present. There is simply the presentation to the public of selected items of information and opinion on the subject of pornography. That, in my view, cannot be regarded as educational in the sense understood by this branch of the law...

Just as important from the point of view of the decisions we must make is the Court's rejection of the argument the Department so often encounters, i.e., that advocacy organizations should be recognized as serving a purpose beneficial to the community in a way that the law regards as charitable as recognized within the fourth category of Lord MacNaghten's classification of charitable purposes. As Neil Brooks has put it (in *Charities: The Legal Framework*, prepared for the Policy Coordination Directorate, Secretary of State, February 1983), "The question is not whether a particular legislative outcome is in itself for the public good, but whether having all sides presented on legislative issues is a public benefit".

The Federal Court dismissed this line of reasoning in the *Positive Action* case, saying (at pages 6190 and 6191):

> ...The essential points which counsel for the appellant seeks to make... is that the public "stands to benefit from the freest and fullest possible public

> analysis, examination, discussion and review of the issues presented and options available and that, as the appellant's actions go to facilitate informed discussion and debate of the subject, they ought to be seen as charitable...
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> ...We are not called upon to decide what is beneficial to the community in a loose sense, but only what is beneficial in a way the law regards as charitable. I am satisfied ... that the appellant's primary purpose or activities cannot be classed as beneficial to the community in this latter sense but rather as political in the sense understood by this branch of the law...

Stone J. then referred to the very thorough examination of political, versus charitable, purposes in the Amnesty International Trust case, *McGovern* v. *Attorney General*, [1982] Ch. 321 to further illustrate this distinction.

So while we may yet see further development of the law on these points through new court challenges, I think it is reasonable to suggest that three propositions represent the current state of the law in Canada, and must serve as guidelines for the Department's registration decisions. The first is that the advancement of education must involve training of the mind, or instruction, or an addition to the store of human knowledge. The second is that an organization that provides the public with selected pieces of information or opinion in order to convince the public to accept one side of a controversial issue will not be advancing education in its charitable sense. The third is that, as in *McGovern*, educational elements within a political purpose will not bring it within the sphere of charitable purposes.

As you know, amendments to the *Act* introduced in 1985 do allow charities greater flexibility to carry out non-partisan political activities in furtherance of charitable purposes. The differences in these concepts can be difficult to grasp, and we would certainly appreciate any suggestions as to how we can help to give both legal practitioners and the public a better understanding of these matters.

There is one other important fact to remember and that is that while the *Act* provides an applicant with the right to appeal the Department's decision to *refuse* registration, the important third party in this fiscal equation—the taxpaying public—does not enjoy a corresponding right under the *Act* to challenge the Department's decision to *allow* registration. And since every decision to grant registration has a fiscal consequence for all Canadian taxpayers—tax revenues foregone must be made

up elsewhere—this places a special onus upon the Department to act responsibly.

Business Activities

Another problem of limits that has emerged in response to the changing environment in which charities must operate is the question of how far a charity may involve itself in business activities, as opposed to investment activities or fund-raising campaigns for donations.

In 1977, the *Act* was amended expressly to permit registered charities to become involved to a limited extent in business activity. The provisions enabled charitable organizations and public foundations to carry on a "related" business, although this term was not directly defined. Instead, the *Act* permitted involvement in any business that was "unrelated to the objects of the charity", provided that it was substantially carried on by volunteers. The provisions were administered in a manner which required a business not carried on by volunteers to have a direct relationship to the accomplishment of the charity's purpose, or to be a necessary concomitant to its charitable activities.

In its 1987 decision in *Alberta Institute on Mental Retardation* v. *The Queen*, 87 D.T.C. 5306, the Federal Court of Appeal established a four-part test to determine whether a business carried on by a charity should be considered a "related" business. This test was adopted by Heald J. from an approach suggested by Arthur Drache in the second edition of his *Canadian Tax Treatment of Charities and Charitable Donations* (1980). Commenting that "while it must be understood that Mr. Drache's approach in this article is more pragmatic than jurisprudential, the tests suggested by him strike me as being in accordance with the statutory scheme as well", at page 5311, Heald J. sanctioned the following four criteria for deciding this issue:

1) the degree of relationship of the activity to the charity;
2) profit motive;
3) the extent to which the business operation competes with tax-paying businesses; and
4) the length of time the operation has been carried on by the charity.

Some legal experts say that the application of this test would mean that, provided "all monies raised" were applied to charitable purposes, virtually any business could be considered to be a related business, subject only to the somewhat imprecise limitations set by the decision

that it not become a "collateral" purpose, or the vehicle of a "substantial" commercial operation. Other experts have advised caution.

It is difficult to evaluate the effect that this widely-publicized decision has had on the extent to which registered charities are becoming engaged in business activity, primarily as a means of raising funds. We know that charities are under increasing pressure to become self-sufficient, and that there is intensifying competition for the charity dollar. We also know that there are important tax policy implications to resolve in light of the *Alberta Institute* decision. Will charities inevitably prove to be unfair competition for tax-paying businesses if few or no restrictions are put upon the nature or extent of their business activities? Will charitable funds be put at undue risk in speculative ventures? Is it truly possible to say that any business activity that cannot, in and of itself, be considered a charitable activity, is without profit motive? And at what point will it be possible to say that the charitable motive or purpose behind a business activity no longer predominates?

The *Alberta Institute* case leaves the Department with two options. It can endeavour to administer the legislation in conformity with the decision, taking either a strict or a generous interpretation, or it can seek an amendment to the *Act* to clarify the legislative intent.

The Department would welcome suggestions from the legal profession on these points and, particularly, on the administrative approach the Department might take to apply effectively the tests set out in *Alberta Institute.*

Finally, I think it is instructive to look at the rules that apply in other jurisdictions. In the United States, the Internal Revenue Service (IRS) code provides for a tax on the trade or business income of an exempt organization where the income-producing activity *is not substantially related* to the exercise or performance of its charitable or other exempt purpose. Income from a trade or business *substantially carried on by volunteers* is also exempted, but the production of income to support the exempt purposes of an organization is not considered an adequate basis for deeming the business activity to be related.

An even more stringent test applies in England and Wales, where a charity is exempt from taxation on only those profits of a trade "exercised in the course of carrying on its primary purpose", or where the business activity is mainly carried out by the beneficiaries of the charity.

Some would argue that the Federal Court test has the potential to permit Canadian charities a much wider scope for business activity than is allowed in other jurisdictions with similar legislative frameworks. Significantly, however, the penalty for carrying on an unrelated business in these jurisdictions is simply that the business income is taxed, whereas under our legislation the registered status of the charity could be in jeopardy.

The Dividends of Co-operation

If I were to be asked what the role of the legal profession should be in today's registration process, I would have to say that I believe the true role of lawyers is, ultimately, to make the concept of charity clearer through better interpretation of case law, and to contribute to the evolution of the case-law concept through well-reasoned argument.

The registration process itself is really quite straightforward, and probably the majority of organizations make application without the assistance of a legal advisor. Where I believe lawyers can, and should, make a difference is in doing more research *before* wording the objects of newly-formed organizations and as a result being better prepared to provide good, solid legal reasoning in support of the application for registration in difficult cases. I am not suggesting that I want to see the process reduced to a game of artful draftsmanship. But I realize that the charities field is a somewhat narrow and esoteric branch of the law—really the realm of only a few specialists in Canada—and is not familiar territory to the majority of lawyers who may be asked to draw up an organization's governing documents. Moreover, work for charities is often done on a *pro bono* basis, or for a nominal fee. As a result, the task of drafting an organization's objects and preparing the documentation for registration often falls to an articled student, is performed hurriedly, or with unsufficient research. Obviously, the legal profession and the Department share a vested interest in ensuring that the process of registering a charity is as free from unnecessary obstacles as possible. I can see two ways in which the Department can be more helpful. First, the Department can begin to publish decisions it takes that can be regarded as precedent-setting or of wide interest to the charities sector. The other is to make available to the Canadian Bar Association all of its case-law files—over 500 cases relating to charity—so that a specialized charity-law information system can be put in place to assist lawyers in setting up charities, and in preparing arguments for

registration. (I have already been in touch with the Canadian Bar Association which welcomes the initiation.)

Implementation of these suggestions would, I believe, do much to avoid situations where time is wasted clarifying the intent behind vaguely or poorly worded objects or where wording must be changed before registration is granted.