Occasional Paper

Charitable Sector Reform: First Steps to Reality

Edward Short, C.P.A., C.M.A.

The Pemsel Case
FOUNDATION

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"The law of charity is a moving subject"
– Lord Wilberforce

About Us

Named after the 1891 House of Lords decision, *Commissioners for Special Purposes of the Income Tax v. Pemsel*, [1891] A.C. 531, which established the four principal common law heads of charity used in Canada and elsewhere, The Pemsel Case Foundation is mandated to undertake research, education and litigation interventions to help clarify and develop the law related to Canadian charities. The Pemsel Case Foundation is incorporated under the Alberta Societies Act and is a registered charity.

The Pemsel Case
FOUNDATION

Suite 1150, 10060 Jasper Avenue,
Edmonton, Alberta, T5J 3R8

www.pemselfoundation.org

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Executive Summary

Issues of complexity and ambiguity in the income tax rules that effectively govern the Canadian charitable sector are longstanding. These rules are administered by the Canada Revenue Agency (CRA).[1] More recently, the previous Conservative federal government was concerned with the use of charities for political activism. In addition to legislative amendments intended to better track and regulate political activities and their funding, the 2012 Federal Budget enhanced the audit program of the CRA through which it ensures compliance with the income tax rules. These rules include those that relate to the political activities of charities.

The enhanced activity by the CRA in turn gave rise to increased media attention to its actions. The media linked the political ideology of the Conservative government to the actions of the CRA. The Liberal party promised that the CRA under their government would "allow charities to do their work on behalf of Canadians free from political harassment, and (would) modernize the rules governing the charitable and not-for-profit sectors."[2]

Following its election, the new federal government set up the Panel on the Political Activities of Charities to consult Canadians, to report on their related concerns, and to recommend reforms. The Panel's focus was on how much charities should take part in political activity, but the Panel could look at that in context.

The Panel's recommendations for change

The Panel recommended CRA administrative changes and changes to the *Income Tax Act* ("ITA").[3] The changes would:

1. redefine permitted political activities,
2. focus on a charity's purposes, rather than activities,
3. recognize some charitable purposes that may not have existed under common law, and
4. allow the Tax Court of Canada to hear appeals of CRA registration decisions.

This paper discusses in more specific terms the legislative considerations and the practical results that might be expected from the implementation of the first two of these recommendations.

[1] The Canada Revenue Agency and its predecessors are collectively referred to as the CRA in this paper.

[2] Liberal Party of Canada, *A New Plan for a Strong Middle Class*, (2015), p.34.

[3] Canada Revenue Agency, *Report of the Consultation Panel on the Political Activities of Charities*, (2017), [Panel Report].

Suggestions for changing definition

Carl Juneau wrote a Pemsel Case Foundation paper: *The Canadian* Income Tax Act *and the Concepts of Charitable Purposes and Activities*.[4] Its main theme was to focus the ITA definition of a "charitable organization" on purposes, instead of activities. Mr. Juneau did an historical analysis of the relevant definitions in the ITA. He suggested that the mention of activities was meant to categorize types of charities, not to set conditions for determining whether their objects were charitable. Removing that mention could reduce inconsistencies in the law and give the courts room to decide if some other purposes are charitable.

One option for a legislative change would be to replace the reference to activities, in the definition of a charitable organization, with words like those in the definition of a "charitable foundation": constituted and operated exclusively for charitable purposes. That could change the focus from the connection of an organization's activities with its purposes to the common-law meaning of charity.

Under this option the definition of a charitable organization might become similar to that of a public foundation (which is itself currently a subset of the charitable foundation definition). Already, the regulatory requirements are similar. A legislative change made in 2010 (eliminating an expenditure rule in the disbursement quota of charities) has made their treatment similar. All charities are eligible to carry on charitable activities and to accumulate endowments and other gifts of capital. The main remaining distinction is a group of rules applied only to private foundations.

Effects on interpretation and administration of the law

The question arises as to whether changing the definition would make any difference in the substantive and practical application of the law. The principle taken under current jurisprudence, that "activities are charitable to the extent that they aim at achieving a charitable purpose"[5], would imply that under the current definition a charitable organization only needs to show that its activities serve a charitable purpose.

Further, the CRA currently already uses similar applications for registration and annual returns for both charitable organizations *and* charitable foundations.[6] The agency might continue to ask charitable organizations to describe their charitable activities in these forms, even under a new legal definition of charitable organization.

Alternative definition

Notwithstanding the above, there may be benefits to legislative amendments if they also bring clarity to the application of the law. Instead of simply amending the "charitable organization" definition, the definitions of "charitable organization" and "public foundation" could be combined as

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[4] Carl Juneau, *The Canadian* Income Tax Act *and the Concepts of Charitable Purposes and Activities*, The Pemsel Case Foundation, (2016), [Carl Juneau]. Available for download at: http://www.pemselfoundation.org/wp-content/uploads/2016/10/Occasional-Paper-The-Canadian-Income-Tax-Act-and-the-Concepts-of-Charitable-Purposes-and-Activities-Final.pdf .

[5] *Ibid*, p.12.

[6] Although the *answers* to some questions will differ as between the different classes of charity. As well, only private foundations that hold corporate shares must include form T2081 with their annual return.

one for public charities.[7] The definitions for both public charities and private charities could require that a charity be established and operated only for charitable purposes (rather than it devote all its resources to charitable activities).

Consequential administrative and legislative changes

Changing the focus for charitable organizations from charitable activities to charitable purposes may have implications for administrative methods of regulation by the CRA. New legislative amendments might be needed to provide clarity in interpretation or to allow relief that would not be available under the common law or other statutory requirements. This in turn raises some policy considerations.

For example, this would require the government to make a policy decision that no public charity would need to carry on charitable activities on its own, just like a public foundation today. A separate rule currently permits a charitable organization to satisfy up to 50% of its charitable activity requirements by way of gifts to registered charities and other qualified donees.[8] This rule would be redundant under the new definition and would be removed.

Furthermore, with a purpose-based test, could it be argued that in some circumstances nobody is required to perform charitable activities? For example, what if a Canadian charity hires and funds a contractor to carry on charitable activities outside Canada, but the activities are not carried out? Could the charity argue that it has met its obligations by operating exclusively for charitable purposes? To prevent this outcome, the ITA could be amended to hold them to account when using service providers.

Changing the rules on political activities

Defining charitable organizations by their charitable purposes would not necessarily change the practical application of the political activity rules. This is so because the CRA applies the rules regarding political activities in the same way to charitable organizations and public foundations.

The government has options for making clear whether it is making a policy change in response to the Panel recommendations. The ITA could be amended to provide that an otherwise non-charitable purpose will be considered charitable if it is pursued only to serve a charitable purpose.

This raises a question whether the level or the type of political activity is at issue. When does the level of political activity (or non-charitable activity) become so significant that it seems to be a primarily political purpose (or non-charitable purpose), not merely in service of a charitable purpose?

As well, this amendment could be interpreted as allowing partisan political activities (in addition to non-partisan activities). It might be necessary to specifically prohibit partisan political activity.

[7] Private foundations could be reclassified as private charities, but this would be a change in name only.

[8] A "qualified donee" is defined in ITA ss. 149.1(1) and is, essentially, an entity eligible to issue charitable donation receipts.

Scope of concerns and predicted results

This paper:

1. describes the significance of the common-law meaning of charity in the context of secondary rules for eligibility as a registered charity, both at the time of registration and ongoing,
2. discusses policy issues arising with the suggested new framework and suggests changes to the secondary rules, and
3. questions the benefit of a clearer framework to the *Income Tax Act* since the Canada Revenue Agency already applies existing rules to charitable organizations and charitable foundations in a comparable way.

Charitable Sector Reform: First Steps to Reality*

Introduction

Longstanding issues of complexity and ambiguity in the income tax rules that effectively govern the Canadian charitable sector have been brought to a head by the audit program of the CRA that was enhanced by the 2012 Federal Budget. This initiative augmented existing audit and compliance measures for registered charities. In 2016, the Panel on the Political Activities of Charities ("the Panel") was struck by the Minister of National Revenue to engage Canadians in consultations, provide recommendations for reform of tax administration and report on other issues arising out of the consultations. Though the focus was in relation to the degree to which charities should be permitted to engage in political activities, sufficient scope was given to allow a broader review. In this vein, the Panel's March 31, 2017 report recommended not only certain CRA administrative changes, but also changes to the *Income Tax Act* (ITA) that would (1) better define permissible political activities, (2) provide a new framework that would focus on charitable purposes, rather than activities, (3) deem certain purposes to be charitable (that may not be under the common law), and (4) allow appeals regarding CRA registration decisions to be heard in the Tax Court of Canada.[9] This paper discusses in more specific terms the policy and legislative considerations and the practical results that might be expected from the implementation of the first two above-mentioned proposals for legislative change.

Existing legislative framework[10]

A tax-exempt registered charity is distinguished from a tax-exempt non-profit organization that is "not a charity within the meaning assigned by subsection 149.1(1)".[11] But the rules governing charities do not generally refer to a charity: rather, they refer to one or more of three classes of entity, which are defined: charitable organization, public foundation and private foundation. The latter two are also subsets of the definition "charitable foundation". The key distinctions are that all of the resources of a charitable organization must be devoted exclusively to "**charitable activities** carried on **by the organization itself**", while a charitable foundation is a corporation or trust "constituted and operated exclusively for **charitable purposes**".[12]

Therefore, when considering these aspects of the definitions, Canadian jurisprudence is not focussed on what a charity is, so much as it is on determining what **activities** are charitable (in the case of charitable organizations) or what **purposes** are charitable (in the case of foundations). Or both, as we

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* The author, Edward Short, retired after 32 years in the income tax field. Mr. Short most recently was a manager in the Finance Canada Tax Legislation Division, specializing in business, personal and property income tax issues. He was actively involved in tax policy and legislative issues relating to charities from 2000 to 2014. He currently lives in Prince Edward Island where he is volunteer Treasurer of the Panmure Island Lighthouse Association and an avid sailor.

[9] Panel Report, *supra*.

[10] References to legislation in this paper are to the federal *Income Tax Act* (ITA) unless otherwise indicated.

[11] ITA para. 149(1)(l).

[12] ITA ss. 149.1(1), italics added. There are certain other characteristics in the definitions, such as relating to control, that do not relate to the issue of the common law.

shall see below.

The ITA diverges at this point into specific rules that apply to the three defined classes of charitable entities. Some of these rules are similar across the classes, but there are also significant differences. For example, there is a provision that provides the CRA (on behalf of the Minister of National Revenue) with the discretion to revoke the registration of a charitable organization or public foundation that carries on a business other than a "related business" (a defined term), while a similar (but different) rule allows revocation of a private foundation for carrying on **any** business.[13] If the CRA or a court considers the meaning of these provisions, they are not applying only the common-law meaning of "charity". They are applying the statutory rules.

Many statutory rules applicable to registered charities are prescriptive, such as the requirement to file an annual information return; and the "disbursement quota" obligation to expend a certain amount each year on charitable activities or gifts to "qualified donees".[14] Other rules add clarity to interpretation of the prescriptive provisions. Still others are relieving, such as a rule that deems resources devoted by a charitable organization to a related business to be devoted to its charitable activities. In this example the rule prevents a decision, based on the common law as it applies to charitable activities, that an entity might not meet the definition of charitable organization because its related business is not a charitable activity.

Understanding the existing framework is important when considering possible legislative changes. The CRA may revoke the registration of an entity as a charity if (1) it does not fall within one of the three basic definitions, (2) it does not comply with rules that it is subject to, either by actions that are prohibited or by failing to act as required, or (3) it does not meet a threshold for relief under a provision that would exempt it from one of the first two requirements.

ITA subsections 149.1(6.1) and (6.2), the statutory rules regarding the political activities of charities, are also relieving rules. That is, they were introduced at a time when the CRA's view of the common law was that resources devoted to political activities were not devoted to charitable purposes.[15] These rules were introduced effective from 1985 to provide relief by deeming that non-partisan political activities that are ancillary and incidental to charitable activities (for charitable organizations) or charitable purposes (for foundations) are deemed to be devoted to charitable activities, in the case of charitable organizations, or deemed to be constituted and operated exclusively for charitable purposes to the extent of the resources so devoted, in the case of charitable foundations. As with the previous example, the rules were introduced to prevent a potential decision, based on the common law (as interpreted by the CRA in 1985), that the definitions of charitable organization and charitable foundation are not met because political activities are not charitable activities or do not have a charitable purpose.[16]

Suppose then that the government were to make a policy decision that registered charities should be permitted to engage in unfettered campaigns advocating for legislative changes and/or government policy changes. A change to the definition of a charitable organization to replace the reference to charitable **activities** with a reference to charitable **purposes** might not give full effect to this policy decision. Although that change might move the focus from political activities to, more directly, the

[13] ITA paras. 149.1(2)(*a*), (3)(*a*) and (4)(*a*).

[14] Defined terms in ITA ss. 149.1(1). The disbursement quota is discussed further below.

[15] CRA Information Circular 78-3, released February 27, 1978 and withdrawn the following May, stated that a charity could have an ancillary political purpose but had to devote all its resources to charitable activities.

[16] The current application of these rules by the CRA is discussed further below.

purpose of those activities, it might not resolve the question as to whether or when a political activity can have a charitable purpose. A more direct approach might be to amend the relieving provision for political activities to specify what activities are permitted under the new government policy.

Charitable purposes v. charitable activities

Comparison of certain rules

Before delving into their application, it may be useful to compare the language in some of the statutory rules that incorporate references to charitable purposes and activities. For the purpose of this comparison, the following table simplifies, reorganizes and paraphrases the requirements of the definitions of charitable foundation and organization and the disbursement quota obligation (which applies to each class of registered charity).

The issues raised in this paper turn mainly on the question of whether the "indirect" activities of an entity, i.e., those activities that do not directly result in the delivery of charitable programs and services, meet the requirements described generally in the table. Most such indirect activities can be lumped into one of the following categories: management and administration, fundraising, business and political activity.

	Charitable Foundation	**Charitable organization**	**Disbursement quota obligation**
Action	Must be (constituted and) **operated**	Must **devote** its resources	Must **expend** amounts
Threshold	...exclusively	...all	...at least equal to its quota (defined)
Object	...for charitable purposes.	...to charitable activities.	...on charitable activities (or gifts to qualified donees).

If, for example, fundraising is not a charitable activity, can it not at least be said that fundraising is **devoted** to charitable activities?[17] Could a foundation not argue that it engages in fundraising exclusively so as to achieve its charitable purposes? If the answer to these questions is no, then how can any foundation or organization that fundraises meet the very high threshold in the statute?

The distinction of the disbursement quota obligation, which applies to all classes of registered charities, is the requirement to **expend** amounts on charitable activities. That is, the statute clearly references a monetary measure, whereas the charitable foundation and organization definitions

[17] Per CRA CG-013, *Fundraising by Registered Charities*, para. 3: "Although a charity can use some of its resources for fundraising to support the charitable activities that further its charitable purposes, it is the CRA's position that *fundraising is not a charitable purpose in itself or a charitable activity that directly furthers a charitable purpose*." (Emphasis added. Note that the basis of the CRA position is not evident from the statutory rules.)

simply say “exclusively” and “all”.

Paragraphs 149.1(6.1)(*a*) and (6.2)(*a*) of the ITA each provide the relief of a “safe harbour” for political activities where an entity devotes **substantially all** (i.e., less than “all”) of its resources to charitable purposes (for foundations) or to charitable activities (for organizations) and devotes **part** of its resources to ancillary and incidental political activity.[18] Note in particular the following:

- The thresholds are not referenced with a monetary measurement.
- The legislative drafter was evidently of the view that the entity would not meet the “exclusively” or “all” tests in the charitable foundation/organization definitions but for the relief provided by the safe harbour. That is, if the entity devoted part of its resources to ancillary and incidental political activity, then it could not meet the exclusively/all test. This is the reason that relief was necessary.
- Further to this, the drafter must have considered that resources devoted to political activity were not devoted to charitable purposes or activities, even if ancillary and incidental to those purposes/activities. As such, the provisions **deem** this to be the result.

It is a separate matter as to whether the drafter was correct in the interpretation of the common law underlying the charitable foundation and organization definitions and whether political activity can be in support of a charitable purpose. (This will be reviewed below.) If the drafter was incorrect, i.e., if political activity may indeed further a charitable purpose or activity, then when can the safe harbour ever apply?

What the CRA asks for

A review of the *T3010 Registered Charity Information Return*, which is required to be filed annually, reveals the following that is pertinent to this discussion:

- A charity is to identify and classify its expenditures according to the charity’s Statement of Operations (which would reflect accounting records).[19]
- The charity is then asked to reclassify those same expenditures under the following separate categories:
    - Charitable activities
    - Management and administration

[18] The term “safe harbour” is not referred to nor defined in the ITA. In this paper it refers to a legislative provision that provides relief from what would otherwise be the result of application of the law, whether under common law or a statute, so long as the facts and circumstances exist that would allow the relieving provision to apply. As such, if a charity or other person can arrange its affairs so that the necessary facts exist, then they may find themselves sailing within the safety of the legislative harbour. The term can also apply to administrative relief, such as the CRA allowance for small charities (in CPS-022, *Political Activities Policy Statement*, section 9) that registered charities “with **less than $50,000** annual income in the previous year can devote up to 20% of their resources to political activities in the current year” (as opposed to 10% for other charities). In this paper, however, the term is used only in the context of legislative relief.

[19] Small charities (e.g., revenues under $100,000) have fewer categories: they break down management and consulting, travel and vehicle and all other expenses.

- Fundraising[20]
- Political activities
- Other expenditures

- The above information is requested for charitable organizations, public foundations and private foundations alike.

It is clear from this form that, even if the CRA considers that resources devoted to some of these activities (say, management and administration) are devoted to charitable activities/purposes, it still asks charities to report expenditures on them as if they are not charitable activities. The charitable organization definition requires the exclusive devotion of resources to charitable activities, and the charitable foundation definition requires that operations be exclusively for charitable purposes. By implication, anything more than an insignificant amount of resources devoted to non-charitable activities would jeopardize charitable registration status.

Yet it is clear that the CRA accepts in principle that expenditures for support activities, like management, administration and fundraising, satisfy the statutory requirements. For instance, it is rare for the CRA to revoke the registration of a charity for engaging in these unavoidable activities, and even then its revokes only when the level of activity is excessive in relation to delivering charitable programs and services.[21] On its face, requiring entities to account for these amounts separately seems irrelevant.

Further, because the CRA asks for expenditure breakdowns for these activities from both charitable organizations and foundations, it is implicit that the CRA considers the activities of an entity to be relevant to determining whether resources have been devoted to both charitable activities and charitable purposes. (Similarly, the *T2050 Application to Register a Charity Under the Income Tax Act* requires largely identical information from applicants regardless of what class of charity they are.)

The policy distinction

What is the reason for the ITA distinction of charitable organizations from charitable foundations?

A proposal for a legislative change to focus the charitable organization definition on a charity's purposes, rather than its activities, is the main theme of a 2016 Pemsel Case Foundation paper by Carl Juneau, *The Canadian* Income Tax Act *and the Concepts of Charitable Purposes and Activities*.[22] This recommendation has been picked up by the Panel, who suggest the development of a new legislative framework to focus on a charity's purposes, rather than activities.[23]

Mr. Juneau provides an historical analysis of the relevant definitions in the Act to suggest that the reference to activities in the charitable organization definition was intended to categorize types of charities, not to set conditions for determining whether their objects were charitable. Removing the

[20] Small charities are not required to break down fundraising, political activity and other expenditures.

[21] For example, see CRA CG-013, *Fundraising by Registered Charities*, para. 59: "Where the resources devoted to fundraising exceed the resources devoted to charitable activities, this is a **strong** indicator that fundraising has become a collateral non-charitable purpose or that the charity is delivering a more than incidental private benefit."

[22] Carl Juneau, *supra*.

[23] Panel Report, *supra*, Recommendation 4(a).

reference would, it is argued, remove inconsistencies in the legislation and potentially give the courts more scope to decide whether the purposes of some organizations are considered charitable.

Mr. Juneau reviews the predecessor classifications of charities in former subsection 149(1) of the ITA, i.e., charitable organization, non-profit corporation and charitable trust, and makes a reasonable inference from a contextual reading of their description that although charitable trusts and non-profit corporations could gift amounts to charitable organizations, charitable organizations were required to carry out charitable activities themselves "to prevent charitable organizations … from circulating funds endlessly or sheltering them without actually using them for charitable relief".[24]

Consistent with this is the observation in the 1976 Budget Paper that

> "Charities in Canada are essentially of two kinds – active charities which provide services and carry out charitable activities; and foundations which distribute funds to be employed by others for charitable purposes."[25]

This observation is made as a statement of fact, though it reflects the statutory definitions. It supports Mr. Juneau's argument that the definitions subsequently introduced (which reflect largely the current ones) were simply a categorization of the different types of charities based on their **activities**: **active** charities versus those that **distribute funds** (for charitable purposes).

The definitions were not intended to substitute the common law meaning of charity and charitable purposes by reference to activities. In Mr. Juneau's opinion,

> "the wording of the definition of a charitable organization in the *Income Tax Act* was in no way intended as a substantive test for registration purposes by requiring the supervisory body to determine whether an organization's activities were charitable in their own right."[26]

The disbursement quota

The 1976 reforms distinguished (public) charitable organizations from public foundations and private foundations. These definitions were moved from the list of tax-exempt entities defined in ITA subsection 149(1) to a new set of provisions in (then) new section 149.1 that prescribe the

[24] Carl Juneau, *supra*, p. 4-5. Note that ss. 149(1) then, as now, is a list of entities that are exempt from tax, not a list of definitions. The pre-1976 terms "non-profit corporation" and "charitable trust" are actually monikers assigned by publishers such as CCH to the descriptions of those corporations and trusts that are exempt because, among other things, they are "constituted exclusively for charitable purposes" (in the case of corporations) or all of their property is held in trust "exclusively for charitable purposes". In contrast, a tax-exempt charitable organization was described in then paragraph 149(1*)(f*) as "a charitable organization … all the resources of which were devoted to charitable activities carried on by the organization itself". It may be argued that "charitable organization" had a non-statutory meaning apart from the description in that paragraph, and that the paragraph then modified the non-statutory meaning in describing which charitable organizations were not taxable. Arguably, that non-statutory meaning would be determined by the common law, implying that the organization must have charitable purposes. That is, unlike the descriptions for non-profit corporations and charitable trusts, there was no need to state the obvious, that resources be devoted to charitable purposes. This nuance for charitable organizations was eliminated with the new (at that time) definition in subsection 149.1(1) – a charitable organization was defined as "an organization (i.e. any organization, not just a charitable one) … all of the resources of which are devoted to charitable activities carried on by the organization itself". Under this structure, we are compelled to focus on the statutory definition – with the focus arguably more narrowed on the nature of the organization's activities – and less on the common law relating to charitable purposes than was required under the former provision.

[25] Department of Finance, *Budget Paper D*, *Charities Under the Income Tax Act*, (1976), p. 4 [Budget Paper D].

[26] Carl Juneau, *supra*, p. 7.

requirements for registration as a charity.[27]

The reforms also introduced the disbursement quota to address concerns about (1) excessive devotion of donation receipts to fundraising costs; and (2) the perceived ability of closely-held non-profit corporations and charitable trusts to reduce income such that then-existing disbursement requirements in the ITA did not apply. Prior to these amendments, the condition for tax exemption for a charitable organization was that it devote all of its resources to charitable activities, while a non-profit corporation or charitable trust was subject to a **capital accumulation** rule that required disbursement of 90% of "revenues" on charitable activities or on gifts to (generally) charitable organizations.[28] Revenues in this case referred to investment income, e.g., earned by endowments, not to the gross value of annual donations of capital.

Over concerns that foundations (initially, private foundations[29]) could artificially reduce their investment revenues, the new 1976 disbursement quota applied to all classes of charities and contained two components: a capital accumulation rule **and** a new expenditure rule. As mentioned previously, a registered charity must expend a certain amount each year on **charitable activities** or gifts to qualified donees. Before the substantial modification of the rule in 2010, all registered charities were required to expend (very generally)

- 80% of the previous year's tax-receipted donations (the "charitable expenditure rule"); and
- 3.5% of assets not used in charitable programs and administration (the "capital accumulation rule").[30]

The disbursement quota did not modify the common-law definition of a charitable purpose. It did, however, require a focus on activities and compel organizations to distinguish expenditures for the delivery of charitable programs and services from those spent on other activities. As well, because the purpose of the charitable expenditure rule was to address the issue of excessive fundraising costs, it became necessary for the CRA to make a distinction between fundraising activities and charitable activities that was not evident from the common law. The 1976 Budget Papers suggested the intention that a minimum amount be expended on "direct charitable activities", implying that fundraising was at best an indirect charitable activity.[31] But the wording in the statute did not distinguish between direct and indirect charitable activities, forcing the CRA to make the distinction on its own in order to give effect to the provision.

Indirect charitable activities

Mr. Juneau argues that, at least for the purposes of the registration of entities, the common law would provide an adequately rigorous standard without reference to charitable activities: "We have to wonder what is the public-policy benefit of such a reference in a field that is already regulated by

[27] Registered charities remain on the list of tax-exempts under para. 149(1)(f).

[28] ITA para. 149(1)(*f*), (*g*) and (*h*).

[29] Budget Paper D, *supra*, p. 5.

[30] Department of Finance, *Budget Plan* (2010), p. 350, [Budget Plan 2010].

[31] Department of Finance, *Budget Paper D*, *supra*, p. 7.

common law."[32] This follows from a review of decisions of Canadian courts that have had to interpret the undefined term "charitable activities" by reference to jurisprudence relating to the law of charitable trusts. The struggle to rationalize the distinction between charitable activities and charitable purposes is evident from the analysis. Yet in the end the Supreme Court of Canada in the decision of *Vancouver Society of Immigrant Women v. MNR*[33] appears to have bridged the gap. In Mr. Juneau's words,

> "*Vancouver* essentially states the applicable common-law rule: activities are charitable to the extent that they aim at achieving a charitable purpose. This includes relief programs (what the Agency tries to label as 'charitable activities' in a restricted sense), but also fund-raising activities, administrative activities, and political activities."[34]

Or, in the nomenclature of the 1976 Budget, charitable activities include not only "direct charitable activities", but also activities that indirectly support a charitable purpose: like fundraising.

Logically, and in contrast to the CRA application of the law described below, this would extend to political activities that further the charitable purpose of an entity, whether those activities are partisan (e.g., in support of a particular party or candidate) or non-partisan (e.g., promoting a position for or against changes to an existing law or government policy). An inference can be drawn from the dissenting opinion in *Vancouver Society* that this is correct.[35] At paragraph 107, Gonthier, J explains that:

> "The political purposes doctrine has a long history in Canadian law, although its basis is a matter of some controversy…
>
> "Very simply, the doctrine provides that political purposes are not charitable purposes… "Yet that does not exhaust the matter, because what is at issue in this appeal are political activities, not purposes. The rule that a charity cannot be established for political purposes does not mean that the charity cannot engage in political activities in furtherance of those purposes."
>
> *(Emphasis in the original.)*

At paragraph 108:

> "(The Society's governing document) does not authorize the Society to pursue political purposes, but merely enables it to engage in political activities in furtherance of its charitable purpose, provided that such political activities are incidental and ancillary to that charitable purpose."
>
> *(Emphasis in the original.)*
>
> "In my view, that does not lead the Society to run afoul of the ITA *or the political purposes doctrine*."
>
> *(Emphasis **added**.)*

[32] Carl Juneau, *supra*, p. 2 and 20.

[33] [1999] 1 SCR [*Vancouver Society*].

[34] Carl Juneau, *supra*, p. 12.

[35] The minority of the court was not in dissent on this issue.

And at 109:

> "The application of the political purposes doctrine simply does not arise."

One might argue that the reference of the Court to the "political purposes doctrine" is *dicta*, given that subsection 149.1(6.2) provided the appellant with the necessary relief from application of the common law. In any event, even *dicta* of the Supreme Court can be compelling.

Political activities

We have seen the ambiguity of the CRA's treatment of management and administrative expenditures as not being for charitable activities (on the T3010 annual return) while at the same time being "devoted" to charitable activities (per the charitable organization definition).

Expenditures on political activities are not afforded the same discretion by the CRA: they are allowed only to the extent of the relief provided by subsections 149(6.1) and (6.2) (even if they are indirectly in support of a charitable purpose). The CRA view of the common law is summarized in CPS-022, *Political Activities Policy Statement*:

> "... a purpose is only charitable if it generates a public benefit. A political purpose, such as seeking a ban on deer hunting, requires a charity to enter into a debate about whether such a ban is good, rather than providing or working towards an accepted public benefit."
>
> "It also means that in order to assess the public benefit of a political purpose, a court would have to take sides in a political debate. In Canada, political issues are for Parliament to decide, and the courts are reluctant to encroach on this sovereign authority (other than when a constitutional issue arises)."[36]

CPS-022 footnotes the English Court of Chancery decision in *McGovern et al v. Attorney General et al*[37], which concerned the Amnesty International Trust. That decision gives examples of political purposes that could not be considered charitable, however, it speaks of "trusts of which a direct and principal purpose is either", followed by the list of examples of political purposes. Judge Slade went on to say

> "I would further emphasize that it (this judgement) is directed to trusts of which the *purposes* are political … the mere fact that trustees may be at liberty to employ political *means* in furthering the non-political purposes of a trust does not necessarily render it non-charitable". *(Parenthetical added.)*[38]

It is therefore arguable that the court decision referred to in CPS-022 was intended to apply in circumstances where a **principal** purpose of an entity was political in nature, and that it suggests that a political **activity** could further a charitable **purpose**.

Subsections 149.1(6.1) and (6.2) were introduced effective from 1985 to provide relief from the CRA's interpretation at that time of the common-law prohibition of political activities. Although the subsequent *Vancouver Society* decision confirmed the relief provided by these statutory provisions (at para. 155), it also reaffirmed (at para. 157) the principle in *Guaranty Trust of Canada v. Minister*

[36] CRA, *Political Activities Policy Statement, CPS-022*, (2003), section 4, [CPS-022].

[37] [1981] 3 All ER 493.

[38] As quoted in Kernaghan Webb, *Cinderella's Slippers? The Role of Charitable Tax Status in Financing Canadian Interest Groups*, (SFU-UBC, 2000) p.143-144.

of National Revenue[39] that an incidental non-charitable purpose that is in support of a charitable purpose does not vitiate the charitable character of the organization.

That being the case, is there any continuing need for the statutory relief?

Subsections 149.1(6.1) and (6.2) are nevertheless useful in that they clarify what activity is allowed and to what extent. More broadly, they make a statement of government policy as to what is acceptable. As for the CRA, it must attempt to give meaning to the provisions.

The current CRA view is that "Under the Act, a registered charity must devote all of its resources to charitable purposes and activities. Notwithstanding this general rule the Act allows a small amount of resources to be used for political activity."[40] It is implicit from this statement that the CRA considers political activities to be allowed only as a result of and to the extent provided by subsections 149.1(6.1) and (6.2). Further, the CRA states that

> "when a charity's purposes are clearly charitable, but it devotes more than the allowable maximum of its resources to political activities, we may consider that the charity is operating to achieve a political objective that is not stated in its governing documents, and it will consequently risk revocation".[41]

In other words, it appears to be CRA's view that

- subsections 149.1(6.1) and (6.2) are **restrictive** provisions, not rules that provide relief from the "all" and "exclusively" thresholds in the charitable organization and charitable foundation definitions respectively;
- a charity may have an unstated, collateral political purpose if its political activities exceed what is allowed by those provisions; and
- "an organization established for a political purpose cannot be a charity".[42]

Potential new legislative structure to focus on charitable purposes

The "quick and dirty" method to implementing the Panel's recommendation for a new framework that focuses on charitable purposes, rather than activities, would be to simply replace the reference to activities, in the charitable organization definition, with words that resemble those found in the charitable foundation definition, e.g., "constituted and operated exclusively for charitable purposes". What follows is instead a more comprehensive suggestion as to what legislative changes could be made to the ITA, with the intention of bringing greater consistency to the rules. The subsequent sections of this paper will discuss policy considerations for the government in introducing such amendments, potential impacts, and whether changes to CRA administration could better resolve

[39] [1967] S.C.R. 133, [*Guaranty Trust*].

[40] CPS-022, *supra*, section 3.

[41] *Ibid*, section 5.

[42] *Ibid*, section 4. Although the CRA professes to accept the *Vancouver Society* as the current common-law authority, its practical application of subsections 149.1(6.1) and (6.2) as *de facto* restrictive provisions (when they are clearly drafted as relieving) is incongruent with the principle that statutory provisions modify the common law, because in this case the common law arguably provides more relief than the statute. One might argue that *Vancouver Society* only refers to political purposes and charitable purposes (not charitable activities), so that subsection 149.1(6.2) is still relevant in providing relief for charitable organizations. If this were the case, however, then one would expect the CRA to have a different application of the law for charitable foundations, which it does not.

the concerns of the charitable sector.

The proposal

This paper proposes that, if the charitable organization definition in the ITA is to be modified to better reflect the common law meaning of charitable purposes, then

- A new definition of "charity" would resemble the existing charitable foundation definition, except that it would apply more generally to an entity, organization or institution. This would be based on the common law for charitable purposes and would apply both at the time of registration and subsequently.
- Subsets of charities would be public charities and private charities. A new definition of a public charity would collapse the existing charitable organization and public foundation definitions. The reference to charitable activities would disappear. The existing rules regarding control of the entity are identical for these two types of charity.
- A private charity would be a charity that is not a public charity. Note that the title is not important: the existing title of private foundation could remain.

The reason that this legislative change is relatively simple is that most of the existing rules applicable to charities apply to all three existing classes of charity. All three classes are permitted to perform charitable works, invest capital and distribute funds to qualified donees. Various rules apply only in respect of private foundations. In short, the characteristics of the different classes are similar, except that private foundations are in closer proximity to their benefactors. As such, there is perhaps less reason to distinguish between the classes as there was in 1976 when the legislative framework was last substantially modified.

The implication of this approach is that, further to the *Vancouver Society* decision, indirect activities such as fundraising could still be considered to be in support of charitable objects.[43] If there were to be limits placed on these activities, it would be necessary to rely on prescriptive rules outside the definitions. So, for instance, the current rules restricting the carrying on of a business or unrelated business could be maintained. Also, presuming that the CRA view of the law remains unchanged, a relieving rule in respect of political activities could remain.

If there is concern that this principle from *Vancouver Society* is not clearly incorporated into the new definitions, then a new provision could allow that a purpose, though non-charitable itself, could be deemed charitable if pursued only as a means of fulfillment of another charitable purpose.[44] Since the CRA already allows (to an extent), necessary management, administration and fundraising activities,

[43] Within limits, as suggested by the Supreme Court of Canada in *Guaranty Trust Co. of Canada v. Minister of National Revenue*, [1967] S.C.R. 133. At page 143, Ritchie, J., quotes Lord Denning in *British Launderers' Research Association v. Hendon Rating Authority*, [1949] 1 K.B. 462 at 467, 1 All E.R. 21:

> "The only qualification - which, indeed, is not really a qualification at all - is that other purposes which are merely incidental to the purposes of science and literature or the fine arts, that is, *merely a means to the fulfilment of those purposes,* do not deprive a society of the exemption. Once however, the other purposes cease to be merely incidental but become collateral; that is, cease to be a means to an end, but become an end in themselves; that is, become additional purposes of the society; then, whether they be main or subsidiary, whether they exist jointly with or separately from the purposes of science, literature or the fine arts, the society cannot claim the exemption."

[44] *Vancouver Society*, *supra*, para. 158.

the necessity of an amendment is more relevant to the discussion below regarding political activities.

Other references to charitable activities

There are various existing rules that refer to charitable activities that fall outside the definitions of the classes of charities. To be consistent, in each instance the words could be replaced with a reference to "activities in support of its charitable purposes". If there is a concern that this is too broad, i.e., capturing fundraising, administrative expenses and political activities, then the word "direct" could be added before "support", or they could be carved out specifically. In either case, the existing administrative burden on charities to segregate the costs would continue.

There are other similar instances where the term "charitable activities" could be replaced, such as the in the meaning of "undue benefit" in ITA subsection 188.1(5), which carves out benefits conferred in the ordinary course of charitable activities. These types of amendments are largely consequential. Still, in each case care would be necessary to ensure that the new terminology has the desired effect.

Issues, consequences and policy considerations

A few fundamental policy issues arise when considering the proposal to merge the charitable organization and public foundation definitions into one for public charities. Some would arise even if an amendment is limited to changing the reference to charitable activities, in the charitable organization definition, to charitable purposes. If no class of charity is required to implement programs and services in order to fulfill its purposes, what assurance is there that tax-subsidized charitable donations will be put to their intended use? If the *Vancouver Society* decision permits the application of funds to subordinate non-charitable purposes, would there be an increase in non-charitable works, e.g., excessive fundraising, political activities or business enterprises (that do not in themselves advance an entity's charitable purposes)? Would the CRA be able to consider current and planned activities of a charity that is seeking registration, or would it be confined to a review of stated purposes? Finally, would the administrative burden on charities due to CRA requirements be any less: and is this one of the objectives of the charitable sector?

Timing: at time of registration vs. an ongoing test

Should an "activities test", if it is appropriate, apply solely as an operations test, and not as an eligibility test for registration?

Whatever the words used in the ITA to define a charity, how they are applied by the CRA is perhaps more relevant. In considering a registration application, would the CRA apply only the amended public charity/private charity definitions, or would it also consider information that would be relevant to the revocation of registration under one of the prescriptive rules? Certainly this is the current CRA approach, even for charitable foundations (for which the definition does not refer to charitable activities).

It is possible to give some policy direction in the legislation. For instance, the new rules could remove the words "and operated" from the current charitable foundation definition.

The approach of the UK *Charities Act, 2011*[45] is to define a charity in its section 1 as (among other things) "an institution which (a) is **established** for charitable purposes only". Sections 2 and 3 then define a charitable purpose as a listed purpose that is for the public benefit. Listed purposes include, for example, the prevention or relief of poverty and the advancement of religion.

Although the Panel has recommended that such a list be considered for Canada, this paper will not address that issue. But the UK law provides a contrast to the ITA by using the words "is established" as compared to "constituted and operated" (for the charitable foundation definition).

Under the UK law, is it possible for an institution to register as a charity because it has charitable objects, but then engage in activities that have primarily a non-charitable purpose (and maybe only a consequential charitable purpose)? Does the regulator have authority to deny registered status at the time of application by the institution if the regulator knows of such activities? Is the regulator entitled to demand information on activities of the institution that might reveal a non-charitable purpose?

This is the subject of a 2014 paper by Jonathon Garton regarding the impact of the decision of the UK Upper Tribunal in *R (on the application of Independent Schools Council) v Charity Commission,* [2011] UKUT 421 (TCC), [2012] Ch 214. Mr. Garton summarizes the effect of the decision and argues that ongoing activities are still relevant:

> "Although the Upper Tribunal stated in the *Independent Schools Council* case that charitable status turns on whether an organization was established for charitable purposes and not, save in the absence of a full, written constitution, on how its founders intended that these would be carried out, nor on how these are carried out in practice, the judgment apparently heralds a new significance for activities insofar as it goes on to suggest that the trustees of – an established charity - i.e. an organization that by definition has already shown that it meets all the elements of the public benefit requirement necessary for charitable status – must show that in practice the charity operates for the public benefit."[46]
>
> *(Highlight added.)*

The issue is far from clear, however. Maintaining the existing wording from the ITA charitable foundation definition would support an argument that the CRA and the courts may consider not only the stated purposes of an organization, but also evidence of any unstated purposes. This consideration could be made both upon application for registration and at any time after. As such, registered charities would need to continue to be cognizant of "mission creep", the evolution over time of the objectives of a charity that may not be stated explicitly in its governing documents.

The Australia *Charities Act 2013*[47] *p*rovides that a charity is (generally) a non-profit entity with only charitable purposes for the public benefit or purposes incidental and ancillary to such charitable purposes. This approach, like that of the ITA, more clearly suggests that the criteria must be met on an ongoing basis, in contrast to the UK rule that leaves some uncertainty as to whether the test applies only on registration. Purposes incidental and ancillary would presumably be allowed in Canada pursuant to the *Vancouver Society* decision, but this is not clear from CRA administrative positions.

The Australia statute goes on to list certain purposes that are presumed to be for the public

[45] UK *Charities Act 2011*.

[46] Jonathon Garton, *Charitable Purposes and Activities*, Current Legal Problems, Vol. 67 (2014), p. 373–407, at p. 393.

[47] Australia *Charities Act 2013*.

benefit, and also to disqualify a purpose that is illegal or to promote or oppose a political party or a candidate for political office. Thus, unlike the ITA, which presumes that illegal and political purposes are not charitable to begin with, and then allows a safe harbour for political activities, the Australia statute guards against an argument that such purposes are charitable under the common law, are somehow included in the statutory list of presumed charitable purposes, or are incidental or ancillary to a charitable purpose.

The approach of the United States *Internal Revenue Code* (IRC) is to exempt certain organizations from income tax, including

> "Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not – participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.[48]
>
> *(Highlight added.)*

Like the ITA, the U.S. rules apply in respect an entity's purposes both when organized, and on an ongoing basis by reference to operations. Also like the ITA, those purposes must be exclusively charitable, which would be determined by reference to the common law, although the tax exemption is extended to include certain listed purposes that may not be considered charitable, such as literary purposes. Finally, a limit ("no substantial part") is put on certain political *activities*. As with the Australia statute, the implication would be that political activities might otherwise be in furtherance of purposes allowed by the provision (contrary to the presumption under which the ITA relief was drafted, that political activities do not have a charitable purpose: but like the ITA, a safe-harbour level of activity is permitted).[49]

It may be that the current process for application as a registered charity in Canada is considered onerous by some, and eliminating the administrative requirement to describe current and planned activities and expenditures of the applicant would certainly simplify that process. The question for the government is whether to signal a policy shift in that direction by not referring to operations in amended definitions. (The proposal described above does not suggest such a policy shift.) If the existing prescriptive rules are to remain nonetheless, then the practical effect of not referring to operations in the definitions might be to create two stages of review for the CRA: one for registration and another, more detailed review, after registration. If the real concern of the charitable sector under the current rules is the administrative burden placed on applicants, it may be worthwhile for the CRA to instead consider whether the current level of information is required at the time of application.

[48] IRC 501(c)(3) Like the ITA, the U.S. rules define private foundations as a subset of these entities, which are then subject to certain special rules.

[49] The U.S. safe harbour for lobbying, i.e., "carrying on propaganda, or otherwise attempting, to influence legislation", is an expenditure test.

Active charities

Charitable organizations currently must devote all of their resources to their charitable activities. However, a relieving rule permits them to disburse income to other qualified donees in lieu of devoting those revenues to their own charitable activities, as long as no more than 50% of those revenues are so disbursed. Charitable organizations are the only class that must perform charitable works. If the charitable organization definition were amended to refer to charitable purposes, instead of activities, or if it were combined with public foundations in a new "public charity" definition, the 50% relieving measure would be of no effect (as long as an entity's gifts to qualified donees were in support of the charity's charitable objectives). Being of no effect, it should be dropped.

But this highlights a policy issue: if charitable organizations were to be allowed to satisfy their requirement, to devote all their resources to charitable purposes, by means of transfers to other qualified donees (as are charitable foundations), what assurance would there be that tax-subsidized donations would actually be put to use, rather than circulating endlessly within the charitable sector?

The answer is: there is already no such assurance. An entity that seeks to register as a charitable organization can about as easily register as a public foundation. The CRA may, as a current practice, classify public entities upon their application for registration in part by reference to the level of planned charitable activity, but this classification may have more to do with the wishes of the applicants, and the historical ordinary distinction between active charities and foundations, than with the ITA definitions.[50]

Notwithstanding the historical factual distinction of active charities from those that fund active charities, under the current definitions there is little legal difference between public foundations and charitable organizations, which must also be publicly controlled. It is, therefore, difficult to rationalize continued distinction in their legal classifications.

As mentioned above, the predecessor classifications were designed to ensure that tax-assisted donations did not cycle endlessly within the charitable sector without eventually being used for charitable works. This policy was changed with the 1976 reforms to introduce the disbursement quota, allowing each class of charity to satisfy its expenditure obligations by way of gifts to *any* qualified donee (while retaining the 50% limit for charitable organizations). If the government wants to return to the policy objective of encouraging disbursement of the funds of foundations for charitable works, then instead of following the path of public vs. private charities, the rules should be amended to go **the other way**, such as by the following:

- Firstly, a distinction between charitable organizations and public foundations would need to be maintained. That is, the proposal to merge them into a class of public charities would not work.
- The charitable organization definition could still be modified to refer to the devotion of resources exclusively to charitable purposes, instead of to charitable activities. Indirect activities like fundraising should satisfy this requirement. If there is doubt that the CRA would agree, then this principle could also be codified.[51]

[50] Although an entity must opt to be structured as either a corporation or a trust if it is to be eligible as a charitable foundation under the existing definitions.

[51] This does not have the same objective as the pre-2010 disbursement quota obligation (discussed below), which had as an objective limiting the proportion of expenditures that were made for *indirect* charitable activities.

- Whether in the definition or in a separate rule, a charitable organization would be limited in the proportion of expenditures that could be made by way of gifts to qualified donees or invested in assets not actively employed. This would result in remaining resources being actively employed or invested in assets that are actively employed.[52]
- When registered charities make gifts to other qualified donees, a minimum percentage could be prescribed for donations to active charities (e.g., entities that are charitable organizations under the current definition).[53]

Such a set of new rules would not prevent a new charity from choosing to set up as a foundation instead of a charitable organization, in order to prevent the limitation on gifts to qualified donees. They would, however, at least require that a proportion of such gifts be made to charities that are subject to that requirement.

This issue can be looked at from the opposite direction: if there is currently little legal distinction between public foundations and charitable organizations, then what is there to be gained by a legislative amendment? The *Vancouver Society* decision appears to have firmly established the link between charitable activities and charitable purposes, and the CRA already demands the same financial information regarding indirect/subordinate activities from both classes of charity. The potential benefits of an amendment should not, therefore, be overstated. There might be some clarity in policy objectives provided by an amendment, but the practical effect might not be significant.

The disbursement quota

The disbursement quota since 2010 is a rule that inhibits the accumulation of capital, and currently should impose no barrier to active charities. In that sense it is of little consequence in this discussion.

That said, there has been from the outset in 1976 an incongruity between the charitable organization definition and the disbursement quota obligation.[54] Both refer to charitable activities carried on by the organization. The former requires exclusive devotion of resources, while the latter sets an expenditure target that would be far less onerous. Conceivably a charitable organization could easily meet its disbursement obligation and yet fall short in its exclusive devotion of resources to charitable activities. Put another way, what is the point of a disbursement quota obligation for a charitable organization that must devote all of its resources to charitable activities anyway? Pity the CRA, who must turn a blind eye to the charitable organization definition in order to give meaning to the disbursement quota. This incongruity would disappear if the charitable organization definition were to focus on charitable purposes instead of activities.

How ironic that, if the disbursement quota obligation were also changed to refer to charitable purposes (e.g., expenditures made in support of charitable purposes), the incongruity would persist. That is, if the charitable organization definition were amended to require the **exclusive**

[52] Unfortunately, rules become more complicated when dealing with endowments received under conditions for their use. A maturing investment (originally acquired with the proceeds of such a gift) might need to be reinvested. Such an action should not be considered an 'expenditure' for the purposes described above.

[53] This is not to suggest that the disbursement quota as it was before 2010 should be reinstated. Because the level of charitable expenditures required under the disbursement quota were related only to donations for which tax receipts were issued, the rule had limited impact on registered charities with significant non-receipted revenues (e.g., from government grants). There was effectively an unequal level of accountability as between charities that relied heavily on fundraising and those that did not.

[54] ITA para. 149.1(2)(*b*).

devotion of resources to charitable purposes, and the disbursement quota obligation were amended to require an expenditure of a **lesser** amount on activities in support of charitable purposes, the disbursement quota obligation would be redundant. Moreover, while the incongruity does not currently exist when applying the charitable foundation definition, if the disbursement quota obligation for foundations[55] were changed to refer to charitable purposes, then a new incongruity would arise for foundations.

There are two ways to deal with this. The first is to eliminate the disbursement quota. This paper presumes that the government would not choose this option, on the basis that the 68 year-old policy, to ensure that the income from capital gifts is put to use for charitable works, remains valid.

Another way, under the proposal to focus the charitable organization definition on charitable purposes, would be to leave as is the reference to charitable activities in the disbursement quota obligation, but to define charitable activities, preferably to refer to "direct" charitable activities as was originally contemplated in 1976. For example, a charitable activity could be defined as an act or service **directly** in support of a charitable purpose that does not include a commercial or fundraising activity; management or administration; or an activity with a political purpose (whether or not in support of a charitable purpose).

The downside of such amendment, from the perspective of charity administrators, is that it would give the CRA continued reason to demand a breakdown expenditures as between direct charitable activities and indirect activities, even though the disbursement quota obligation is easily met and somewhat irrelevant for active charities. Even if no legislative amendments are made, the CRA could consider whether all charities need to provide this level of detail. For instance, questions could be asked on the T3010 annual information return as to whether a third-party fundraiser has been engaged, or whether expenditures on any combination of management, administration, fundraising or political activity exceeds 50% of total expenditures.[56] If the answer were 'yes', then the return could request a breakdown.[57]

On a more minor point, the current threshold for the application of the disbursement quota to charitable organizations is lower than that for public foundations ($25,000 minimum investment capital, versus $100,000).[58] If the charitable organization and public foundation definitions were to be merged, then a consistent threshold would need to be selected.[59]

Accountability – foreign aid and other gifts to non-qualified donees

If charities are not required to fulfill their charitable purposes directly, then they may be further

[55] ITA paras. 149.1(3)(*b*) and (4)(*b*).

[56] The rationale for a 50% level is that at some point it might be argued that the purpose of these activities is a primary non-charitable purpose, not a subordinate purpose in support of a charitable purpose. At what level should this issue be flagged on the T3010? The answer is subjective.

[57] There is a third option, applicable only to charitable organizations, which could reduce the paper burden on charities but would represent a significant policy shift for the disbursement quota (DQ) obligation. The required DQ expenditure could be on activities in support of charitable programs, i.e. all activities, both directly and indirectly in support of them.

[58] Variable B in the "disbursement quota" definition, ITA ss. 149.1(1).

[59] The T3010 Registered Charity Information Return currently asks for a detailed expenditure breakdown for all charities with annual revenues over $100,000 or investment capital over $25,000, even though charitable organizations with less than $100,000 in investment capital have no disbursement quota obligation (regardless of income level).

removed from the actual resulting activities. For example, a Canadian charity that hires and funds a foreign contractor to engage in charitable activities outside Canada might argue that it cannot be held responsible if the activities are not carried out: it has met its obligations by operating exclusively for charitable purposes.

This is a situation where the choice of legislative language under the proposal could signal a change on government policy. ITA paragraphs 149.1(2)(*c*), (3)(*b.1*) and (4)(*b.1*), which apply to charitable organizations, public foundations and private foundations respectively, all permit the CRA to revoke charitable registration if the entity makes a gift to anyone other than in the course of its charitable activities or to a qualified donee. A Canadian charity is therefore unable to make gifts to foreign charities or other non-qualified donees (e.g., Canadian non-profit organizations) to aid them in their relief efforts unless the Canadian charity can show that the gifts are made in the course of delivering charitable programs and services itself (such as a charity that gives snowsuits to families in need). In this regard, the CRA accepts that a Canadian charity can retain direction and control of activities performed on its behalf by a third party through an agency agreement or a contract for services. The distinction is admittedly ambiguous: direction and control of a contractor exists only to the extent that the contract can be enforced.

Leaving the language of these provisions as is should not change their application. In contrast, changing the words "in the course of charitable **activities** carried on by it" to, for instance, "**in support of** activities that further its charitable **purposes**", might signal that charitable programs need not be delivered by the Canadian charity directly. (The words "or to a donee that is a qualified donee" would remain relevant, but only in respect of gifts that are not tied to activities.)

Changing the words to instead simply say "in support of its charitable purposes" would make these provisions redundant if made in tandem with the general proposal to remove the reference to activities in the new public charity definition, since the entity would be required to operate exclusively for its charitable purposes in any event.

As such, if the general proposal is adopted, then these provisions could be either

1. maintained as is (no change to the current policy);
2. dropped, if the government were to decide that a charity need not be responsible for ensuring that gifts to third parties (other than qualified donees) are directed to charitable programs and services: that is, it would be sufficient that gifts further the charitable purposes of the charity; or
3. amended to allow a charity to make a gift to a non-qualified donee, if made in support of activities that further its charitable purposes. This would be a subtle policy change: the charity would not be required to execute activities itself, but would remain responsible for ensuring that gifts to non-qualified donees are actively employed.

The third option would nonetheless be a significant change. For instance, suppose a missionary to an impoverished foreign country, not registered as a charity, were canvassing a Canadian church for support of a project to provide mosquito nets for the prevention of disease. Members of the congregation might want to support the missionary, but a direct donation would not be eligible for a tax receipt, and a donation from their church would not be allowed (absent an agency agreement or a contract for the missionary to provide the charitable program on behalf of the church). Under the second and third options for amendment, members could donate to their church and receive a tax receipt, while the church could make a gift to the missionary. In the case of the third option, the church elders/trustees would arguably have a duty to show that the gift was intended for an active

program.

The degree of accountability implied by the third option is admittedly unclear. A legislative amendment would invariably give rise to arguments as to how the new rule should be applied, initially without the benefit of direction from the courts. To reduce ambiguity, an additional level of scrutiny by a charity could required by the ITA.

The United States *Internal Revenue Code* has an interesting comparable. An organization that is not tax-exempt can engage with a tax-exempt "fiscal sponsor" (e.g., a charity) if the former is willing to relinquish to the sponsor control of the funds raised. Funds raised may be directed by donors as for a specific project (a "donor advised fund"), but the sponsor retains the right to decide how to use the funds. There are two types of sponsorship: one where the sponsoring tax-exempt controls the project, including rights of ownership and assumption of liability (the sponsored organization might carry out the work, but only under contract with or as agent for the sponsor); the other where the sponsored organization controls the project.[60] Distributions from such a fund to a donee to **other than** one listed in IRC 170(b)(1)(A) (essentially a qualified donee for charitable donation deduction purposes) are subject to an excise tax[61], **unless**

- made for one of a limited list of public policy purposes[62]; and
- the sponsoring entity exerts "all reasonable efforts and to establish adequate procedures
    1. to see that the grant is spent solely for the purpose for which made,
    2. to obtain full and complete reports from the grantee on how the funds are spent, and
    3. to make full and detailed reports with respect to such expenditures to the (IRS)".[63]

A similar review and reporting rule could be introduced for Canadian charities. Arguably there would be less accountability than under current CRA requirements. For instance, a requirement to file reports should be less onerous than the current requirement to keep books and records of a third-party's activity (on the charity's behalf). However, the practical result would depend on the level of detail that CRA would demand under the new reporting requirement. A complimentary intermediate sanction for non-compliance might be considered for Part V of the ITA.

[60] Gene Takagi, *Fiscal Sponsorship: A Balanced Overview*, Nonprofit Quarterly, January 19, 2016.

[61] U.S. Department of the Treasury Internal Revenue Service, Publication 557, *Tax-Exempt Status For Your Organization*, January 2017, p. 63.

[62] IRC 170(c)(2)(B), "(R)eligious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals."

[63] IRC 4945(h). Also, "(a) private foundation is not an insurer of the activity of the organization to which it makes a grant." (Code of Federal Regulations 53.4945-5 - Grants to organizations.)

Carrying on a business

Currently there are specific ITA prohibitions against carrying on a business unrelated to the charitable purposes of a charitable organization or a public foundation, and against carrying on any business in the case of a private foundation.[64] A related business is deemed to include a business carried on substantially all by unremunerated volunteers.[65] These prohibitions are prescriptive rules outside of the current definitions, meaning that they are in effect a **second** hurdle for a charity carrying on a business: the first hurdle is that the resources devoted to the business must be also considered devoted to charitable activities (in the case of charitable organizations) or that the entity be operated exclusively for charitable purposes (in the case of charitable foundations).

Under the legislative proposals discussed above, an entity's "social enterprise" (a term which as yet does not appear to have a settled ordinary or legal meaning) in support of a charitable purpose might be able to leap the first hurdle, but to allow such a business the government would have to consider whether to remove or amend the second hurdle. For instance, an entity with a purpose of providing affordable housing in an integrated neighbourhood might be able to develop for-profit housing units as a tool for supporting the not-for-profit units. It might be argued that, from a policy perspective, meeting a "destination of funds" test should be sufficient, i.e., if the profits are to be used for charitable works in support of the charity's charitable purposes, then the carrying on of the business should be allowed.

But the policy issue for government is not so straightforward. Charities may compete with taxable businesses: the investment capital of a registered charity may be subsidized by tax-deductible donations, or even more directly by government grants. Some charities provide services that were at one time public goods, such as fitness facilities, that are now also provided by taxable businesses. Some charities serve a market (e.g., the poor) that is targeted as well by businesses that have no public-benefit motive. The environment created by the existing prohibitions is not black-and-white, but it is not as grey as it would be if they were repealed.

Providing allowances for social financing would require clear definitions of what activity would be considered acceptable.

The ease with which the existing rules prohibiting business activity may be subverted makes moving forward with this issue less relevant. It may of little concern to a charity that it cannot carry on a business. This is because, alternatively, the charity can be the beneficiary of a taxable trust (carrying on the equivalent business) to whom the trustees can allocate all the trust's business profits (non-taxable in the charity's hands). A charity may also own a corporation that donates its income to the charity (rather than paying dividends), thereby paying tax on as little as 25% of its income.[66] If the government is to consider revisions to the rules regarding business activities of charities, then it should consider these arrangements at the same time.

In short, changing the charitable organization definition to reference charitable purposes instead of charitable activities would not change the status quo because the current restrictions are prescriptive

[64] ITA para. 149.1(2)(*a*), (3)(*a*) and (4)(*a*). Subsection 149.1(6) deems the resources of a charitable organization devoted to carrying on a related business to be devoted to charitable activities, so as to meet the criteria in the charitable organization definition that *all* resources be devoted to charitable activities. If the reference to "charitable activities" were changed to "charitable purposes", or if charitable organizations and public foundations were merged under one definition, a consequential technical amendment would be needed to this provision as well. This is not the policy issue discussed here.

[65] ITA 149.1(1).

[66] ITA para. 110.1(1)(*a*) limits a corporation's charitable donations deduction to 75% of income.

rules outside of the definitions. It is therefore a separate issue as to whether the current policy should be maintained, although the ability to plan around the existing rules renders them less effective.

Acquisition of control of a corporation

An existing rule allows the CRA to revoke the registration of a public foundation that acquires control of a corporation. (However, this only applies where the foundation has purchased for consideration more than 5% of a class of corporate shares.[67]) This would be the only distinction between charitable organizations and public foundations if the reference to charitable activities in the charitable organization definition were changed to refer instead to charitable purposes. If those classes of charity were merged, then should the new definition allow acquisition of control of a corporation, or not?

This rule was introduced in 1950 for non-profit corporations and charitable trusts, concurrent with a rule prohibiting the carrying on of a business. Implicitly the rule was to prevent a non-profit corporation or a charitable trust from doing indirectly (through a corporation) what was not permitted if done directly. Both restrictions were moved with the 1976 reforms from the definitions to the rules permitting the CRA to revoke registration. However, charitable organizations and **public** foundations were then permitted to carry on a "related business" (a defined term). The prohibition on a **private** foundation from acquiring control of a corporation was removed with the 2007 introduction of requirements on private foundations to divest of any corporate shareholdings above 20% of any class of shares.

Arguably the rule preventing the acquisition of control of a corporation is now an outlier given that a public foundation may carry on a related business, is not subject to the divestment rules to which private foundations are, and may still acquire control by certain means such as by a donation of shares. As such, this rule should arguably be dropped if charitable organizations and public foundations are merged into one class of public charity.

Long-term debt

Public and private foundations are not permitted to incur debts, other than (in general) for current expenses, for administering charitable activities, or debts related to the purchase and sale of investments.[68] Charitable organizations have no such restriction. Under the proposal to combine the charitable organization and public foundation definitions, a decision would be necessary as to whether this restriction should be included going forward or dropped.

When introduced in 1950 (for charitable trusts and non-profit corporations), these rules precluded debts except those arising in respect of current operating expenses. They were relaxed slightly in 1977 when the new foundation definitions were introduced, and have not changed since.

There is little background material that would allow one to deduce the policy basis for these rules. They were introduced amidst concern that foundations could be used to operate businesses and that the profits might be distributed to the founders/trustees through related-party arrangements. One might speculate that a trustee could have loaned funds to a foundation, to be invested in a business,

[67] ITA para. 149.1(12)(*a*).

[68] ITA para. 149.1(3)(*c*) and (4)(*d*).

and that the business profits could have been repatriated to the trustee through interest payments.[69] In any event, the current rules restricting the carrying on of an unrelated business and the sanctions for distribution of benefits to insiders might provide sufficient opportunity for the CRA to address such a scenario.

The Ontario Law Reform Commission, in its 1996 *Report of the Law of Charities*, concluded that these rules were intended to reduce the risk to which foundations could be exposed, but that there is not sufficient justification for them, and recommended "that they be abolished".[70]

Political activities

As mentioned above, the existing safe harbour for political activities was introduced to provide relief from an interpretation of the common law (at that time) positing that resources devoted to political activities are devoted to political purposes and that an organization established for a political purpose cannot be a charity. The ITA provides relief for non-partisan political activities that are ancillary and incidental

- to charitable **activities**, for charitable organizations, by deeming them to be devoted to charitable activities; and
- to charitable **purposes**, for foundations, by considering them as part of the exclusive operation of the foundation for charitable purposes.

If charitable organizations and public foundations were merged into a public charity definition, with a focus on charitable purposes instead of activities, then the concurrent relieving provision for political activities would need to refer as well to charitable purposes. This would be, however, only a technical change. It would not address the policy issues as to what types of political activities should be permitted, and to what extent. The search for the "right" answer to these questions is a quest: there may not be a holy grail.

The issue of permissible political activities is not, in the end, implicated by the issue of defining charitable organizations by reference to charitable activities. The relieving rule for charitable foundations already refers to resources devoted to charitable purposes and to political activities. The *Vancouver Society* decision has not caused the CRA to apply relief in one way for charitable foundations and in another for charitable organizations.

The government has other options for making clear whether it is making a policy change in response to the Panel recommendations:

- By doing nothing, which would affirm its view that political activities (including non-partisan political activities) are only allowed to the extent already provided for in the ITA.
- By the CRA changing its application of the law, to suggest that devotion of insignificant resources to political activities that are consequential to and in furtherance of charitable purposes are also considered devoted to charitable purposes/activities and do not compromise

[69] Assuming the trustee were taxable, the benefit would have been deferral of tax while the profits were retained in the tax-exempt charity. This benefit may have been eliminated by rules introduced in 1981 to tax accrued interest and to deem interest to have accrued (in ITA s. 12 and Part LXX of the *Income Tax Regulations*).

[70] Ontario Law Reform Commission, *Report on the Law of Charities, Volume I* (1996), p. 364.

the charitable status of an entity. Note that this effectively accepts that subsections 149.1(6.1) and (6.2) are redundant in that under the current view of the common law there is **no limit** on the extent of political activity allowed, so long as it is not so extensive so as to suggest a **primary** *political purpose.* [71] Note also that, absent a specific prohibition inserted into the ITA, partisan political activity would, arguably, be allowed.

Such a change in CRA interpretation would suggest that the existing relieving ITA provisions are in need of revision or repeal, since they would not apply as envisioned. If left as is, the existing safe harbour would only apply when there are political activities that are **not** in furtherance of the charity's charitable purpose.

- As was described earlier, a new provision could allow that a purpose, though non-charitable itself, could be deemed charitable if pursued only as a means of fulfillment of another charitable purpose. Note that this would apply not only in respect of political purposes, but also in respect of any other non-charitable purpose, such as the carrying on of a business.[72]

  There would remain the question of when the level of political activity (or other non-charitable activity) becomes so significant as to signify a primarily political/non-charitable purpose, as opposed to being subordinate to a charitable purpose. Also, a specific prohibition of partisan political activity would be required (if so desired).

  The existing provisions relating to political activities are **relieving**. They would become redundant with the introduction of this new provision. If specific limits on extent or type of activity were desired, new **restrictive** provisions would be required.

- An ITA amendment could instead be targeted to political activity (i.e., not to all activities). The ITA could provide that a purpose of an entity is not precluded from being a charitable purpose solely by reason of activities (exclusively in support of that purpose) that attempt to influence government policy or legislation (unless those activities include partisan political activities).[73]

  As with the previous option, there would remain the question of when the level of political activity becomes so significant as to signify a primarily political purpose. Without a stated limit, activity under this proposal would undoubtedly increase from the current level. If activity were to be limited to an insubstantial or insignificant devotion of resources, then there would not much point to amending the current law.

  As with the previous option, if specific limits on extent or type of activity were desired, these new or amended limits would be restrictive, not relieving.[74]

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[71] *Vancouver Society*, *supra*, para. 158.

[72] Some of the drawbacks in the "purpose-based" approach are explained by Adam Parachin in his paper, *Policy Forum: how and why to legislate the charity-politics distinction under the* Income Tax Act, Canadian Tax Journal / Revenue Fiscal Canadienne (Canadian Tax Foundation, 2017, 65:2, p. 391-418) [Adam Parachin]: "The first objection is that the common-law methodology is too inexact. An activity must be connected to charitable purposes in order to be charitable, but the precise nature of the requisite connection is a matter of some uncertainty. Similarly, there is no universal agreement on the precise point at which an activity ceases to be the means of fulfilling charitable purposes and becomes a non-charitable purpose in itself."

[73] This is essentially the proposal of the Panel. This is to deal with the finding in *Bowman* v. *Secular Society*, [1917] AC 406, which "the court has no means of judging whether a proposed change to the law will or will not be for the public benefit".

[74] Adam Parachin (*supra*, p.411-412) proposes a "complete code" for amending provisions in the ITA, i.e., rules to describe what political activities are allowed and to what extent, without reliance on the common law to establish the link between political activities and charitable purposes. One proposal is to use a secondary rule to allow the CRA to revoke registration if a charity devotes resources to (generally) a partisan political activity or to any political activity (unless the activity in furtherance of the charity's purpose and

The existing provisions use the words "substantially all" and "incidental" to measure levels of activity. There is usually some ambiguity in interpretation when words such as these or the word "primarily" are used. To apply them requires a review of all the facts and circumstances, not just a review of numbers. But they are preferable in the case of a provision that refers to a variable that is not readily measurable. They convey a principle that the facts should be taken in context and in consideration of the intent of the provision when it is applied to any given situation.

Bright-line tests in the law (like a percentage of expenditures) are usually more clear, but they are also subject to avoidance and misapplication. As discussed above, the United States places restrictions on certain tax-exempt organizations that bear some resemblance to the ITA safe harbour permissions for non-partisan political activities. An elective bright-line expenditure test provides an opportunity to carry on substantial political activities so long as costs are held down, e.g. by relying on unpaid volunteers and using web-based publication. Within these rules, some organizations appear to have been quite influential in promoting political views in the U.S., or at the very least in riding a populist tide.[75] Depending on the perspective of the observer, it might be concluded that the bright-line expenditure test has not served its purpose.

The existing ITA provisions do not currently refer to expenditures as a measure of political activity: instead they already refer to the devotion of resources. Nevertheless, the CRA currently requests that charities provide a financial accounting of political activity in the T3010 annual information return.[76] The CRA could reconsider this practice. The administrative burden on charities of compiling this information should be weighed against the advantage gained by the CRA in those rare cases when charities might be have their registrations revoked as a result of their political activity.

Leaving aside jurisprudence and considering policy options, there are only subjective answers to the questions of what type of political activity should be allowed and to what extent.

Advocates of free speech might argue that any activity, partisan or not, should be allowed, and to any extent, so long as the purposes of an entity remain charitable. However, it is arguable that there is already a deliberate policy of supporting the democratic process through the tax system, by providing a deduction from taxable income for political contributions: i.e., that additional support should not be provided indirectly through the charitable donations tax credit and deduction.

Conclusion

The report of the Panel on the Political Activities of Charities recommended, among other things, changes to the ITA that would better define permissible political activities, and modernization of the legislative framework in the ITA to provide a new framework that would focus on charitable purposes, rather than activities. If a new framework is desirable, this paper suggests reclassifying

substantially all of the charity's resources are otherwise devoted to charitable purposes/activities). As described, this is a secondary rule, i.e. it presumes that the entity has already met the criteria of the charitable organization and charitable foundation definitions. Here is where the pitfalls of relying on the common law remain. To be a complete code, such a rule must both provide certainty that political activities are allowed and at the same time set the limits of their permission. Mr. Parachin suggests an alternative approach that would both permit and limit non-partisan activities.

[75] Robert O'Harrow Jr. and Shawn Boburg, "How a 'shadow' universe of charities joined with political warriors to fuel Trump's rise", *The Washington Post*, June 3, 2017.

[76] Except small charities: those with less than $100,000 in revenues or $25,000 in passive/investment assets.

charitable organizations and public foundations into a new public charity definition. It would be required that all charities be constituted and operated exclusively for charitable purposes. Some concurrent technical changes would be needed to provide consistent terminology in rules other than the definitions. For the most part, however, the effect on charities would likely be minimal, for three reasons:

- The CRA already requests largely the same information from charitable organizations as from public foundations, so a focus on charitable purposes in the newly defined class of public charity would not give the CRA much reason to change.
- Most ITA rules affecting charities relate to initial and ongoing eligibility for registration by the CRA and do not depend on the common-law meaning of a charity. Some technical changes to these rules may be consequential to the creation of a new definition, however, these would only be to maintain existing policy objectives. More substantial changes would require policy decisions by the government.
- If the real issues facing charities relate to administrative burden or interpretation and application of the law by the CRA, these issues will not necessarily be resolved by greater focus on charitable purposes.

In the course of considering this proposal, the government could consider the following policy issues:

- Whether the ongoing or planned activities of a charity should be relevant to classification: whether they should be relevant upon application for registration to the CRA, or instead only to the application of specific rules that apply post-registration.
- Whether there should remain a class of charities that are "active" in performing charitable works, where currently there is no need for any new charity to subject itself to stricter obligations by setting up as a charitable organization instead of as a public foundation.
- Whether the disbursement quota obligation should be clarified to refer to expenditures on activities that **directly** support charitable purposes.
- Whether there should be, in conjunction with the new framework, a reduced level of accountability of Canadian registered charities for charitable works carried out by third parties, e.g., overseas, and whether in particular new rules should be introduced regarding the level of accountability required.
- The proposal does not affect the current rules that restrict the carrying on of a business. Should they be relaxed concurrently with the introduction of the new framework? Should public charities be restricted from acquisition of control of a corporation?
- Should the prohibition on foundations incurring long-term debt be repealed?
- The proposal would not affect the level of political activity allowed under the current CRA view of the law. Should an ITA amendment allow more activity than is currently allowed, and if so, to what extent?

These issues can also be considered in absence of a general change to focus more on charitable purposes for charitable organizations. The main benefit of a single definition for public charities is likely the added clarity to be gained by a more streamlined legal framework.

However, given that the CRA already applies the ITA to charities in a relatively homogeneous manner, it would be best not to have overly optimistic expectations that legislative changes could provide

charities with resolution to their concerns.

Regarding political activities in particular, the current CRA interpretation is arguably at odds with the *Vancouver Society* decision, but the existing ITA relieving provisions were drafted under the presumption that the common law does not allow political activities. If the CRA were to revise its application of the law, then those provisions would need to be revised not only to implement government policy, but also because their application would be very unclear under that new position. The Panel's suggestion is one option for applying the principle in *Vancouver Society* to political activities, but it would still require the government to consider whether and how to limit the extent of political activity that would be allowed. If the level of permissible activity were to be anything more than an insignificant amount, then there would not be much point to an amendment.

The Pemsel Case
FOUNDATION

Suite 1150, 10060 Jasper Avenue,
Edmonton, Alberta, T5J 3R8

www.pemselfoundation.org