

# Memorandum

**From:** Mr. Paul Barbeau

**Re:** General Overview of the Law of Charities and Non-Profit Organizations

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## I. Introduction

This memorandum will set out the general law and regulatory environment relating to the establishment and operation of a charity and a non-profit organization in Canada. In addition, the legislative framework for establishing an “association” between a charity and another entity (e.g. a charity, a non-profit organization, a public or private foundation, etc.) will be examined. Finally, the process for de-registration of a charity and the cessation of a non-profit organization will be reviewed.

## II. Charities

For an organization to get the benefits available under the *Income Tax Act* (Canada) (the “ITA”), in respect of charities, two main criteria must be met.

Firstly, the organization must be a charity. That is to say, the objects of the organization must fall within one of four well-considered charitable categories (N.B. *Pemsel v. Special Commissioners of Income Tax [1888] to all E.R. 296*). The four categories of charitable objects can be summarized as follows:

- a) The relief of poverty;
- b) The advancement of religion;
- c) The advancement of education; and
- d) Other purposes of a charitable nature beneficial to the community as a whole.<sup>1</sup>

Secondly, the organization with charitable objects must be registered as such with Revenue Canada. The ITA requires that a charity be constituted and operated exclusively for charitable purposes and that a charitable organization devote all of its resources to charitable activities.

### a) Registration as a Charity

The procedure for registration of a charity is relatively straightforward, and requires that:

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<sup>1</sup> Organization relying on the fourth category may experience a greater degree of resistance by Revenue Canada officials, in applying for registration, in that this category is somewhat amorphous and vague.

- i) The organization<sup>2</sup> must be charitable (i.e. pursuant to its objects); and
- ii) A duly completed form T2050, along with the relevant documents, must be submitted to the Registration Branch of Revenue Canada.

The information required by form T2050<sup>3</sup> generally quite straightforward; however, certain additional factors must be considered.

Firstly, the society or trust should have at least three directors/trustees, at least the majority of whom must be resident in Canada. The constating documents of the charitable organization must provide that, upon dissolution, the assets shall go to another registered charity or qualified donee in Canada. In addition, the constating documents should contain a provision that the organization is **not** to be carried on for profit and that no part of the income of the organization will be payable to any member (N.B. this last point does not preclude members from being paid “reasonably” for services rendered).

Along with a copy of the constating documents of the charitable organization that accompany the application for registration as a charity (i.e. form T2050), the applicant must provide a statement of activities setting out clearly how it intends to operate and what it intends to do. Again, all of the stated objectives must be charitable. Moreover, the applicant must provide a statement of receipts and disbursements and a statement of assets and liabilities, if the entity has operated previously as a non-charity.

Finally, as far as timing is concerned, Revenue Canada normally states that the registration process may take four to six week; however, four months or more is not uncommon.

#### **b) Operation as a Charity**

Given Revenue Canada’s very limited ability to scrutinize charities during their existence, Revenue Canada’s primary focus, as far as compliance with the ITA and regulations is concerned, is at the registration stage. Having said that, the main tool relied upon during the ongoing operations of the charity is the registered charity information return, which a charity must complete and file on an annual basis (N.B. form T3010).

In addition to ensuring that the charity is in substantive compliance with the requirements as setout on the registered charities information return, the charity and its management must ensure that, at all times:

- i) All resources are devoted to charitable activities;
- ii) There must be no benefit to members;
- iii) More than 50% of the directors must be arms length; and

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<sup>2</sup> Generally speaking, the organization will be a non-share company/society or a trust. Difficulty can be encountered at Revenue Canada if it is neither a non-share company or a trust.

<sup>3</sup> Form T2050 is currently being revised by Revenue Canada and is not available.

- iv) At any time in its lifetime, not more than 50% of its capital contributions can come from a person or group of people not dealing at arms length. That is to say, it must have broad support.

The information above generally sets out the process for registration and the obligations of operating as a charity in Canada.

### **III. Non-Profit Organizations**

In contrast to charitable organizations, non-profit organizations need not be registered to achieve their tax status. Non-profit organizations are free of tax so long as they meet the statutory definition. It could be said that operating through a non-profit organization is easier and more desirable than operating as a charity, save only for the fact that such status does not confer on the organization the right to issue receipts for donations which will sustain tax deductions.

#### **a) Definition of Non-Profit Organizations**

Subsection 149(1) of the ITA exempts various types of organizations from income tax. One of these, “non-profit organizations”, is defined at paragraph 149(1)(l) and includes the following list of exemptions:

“A club, society or association map, in the opinion of the Minister, was not a charity within the meaning assigned by subsection 149.1(1) and that was organized and operated exclusively for social welfare, civic improvement, pleasure or recreation or for any other purpose except profit, no part of the income of which was payable to, or is otherwise available for personal benefit of, any proprietor, member or shareholder thereof unless the proprietor, member or shareholder was a club, society or association, the primary purpose and function of which was the promotion of amateur athletics in Canada”

A number of important issues arise out of this definition.

Firstly, the form of the organization is not limited in any way by the ITA.

Secondly, the organization can not be one which would be registerable as a charity, in the opinion of the Minister.

Thirdly, despite the listing of objects, the final phrase in the middle of the definition, “for any other purpose except profit” makes it clear that there is no limit on the nature of the activities of organization whatever, except that it cannot be for the purpose of making a profit. It should be noted that this does not mean that a qualifying organization cannot make a profit, merely that this is not the object of the organization.

Fourthly, as in the case of charities, no part of their income can be available to a member or proprietor for personal use.

In this regard, where the non-profit organization is a corporation or company, steps should be taken in the constating documents to ensure that no dividends can be paid to members or shareholders. Moreover, the constating documents of the non-profit organization should provide that, upon the winding-up of the organization, the assets will not be distributed to it's

members. Failure to meet both of these requirements will, in and of themselves, disqualify an organization from an exemption under paragraph 149(1)(l).

Finally, as mentioned before, the tax exemption status is not based on any registration procedure. Having said that, non-profit organizations with significant income or assets have had an obligation, since 1993, to file an annual report under the provisions of section 149(12).

**b) Not for Profit**

As mentioned earlier, a key element necessary for an organization to qualify under paragraph 149(1)(l) is that it is not pursuing a profit in its activities.

In 1983, Revenue Canada issued a very detailed interpretation bulletin (N.B. IT-496) dealing with non-profit organizations. The most controversial part of that bulletin deals with the department's interpretation of the hallmarks of profit making activities which are unacceptable. The hallmark of such activity include:

- i) An activity operated in the "normal commercial manner";
- ii) A situation where the goods or services offered are not restricted to members and their guests;
- iii) It is operated on a profit basis rather than a cost recovery basis; or
- iv) It is operated in competition with taxable entities carrying on the same business.

It should be noted that these "tests" have been developed by Revenue Canada and have not been tested in a court of law.

In the case of *L.I.U.N.A. Local 527 Members Training Trust Fund v. Canada*, 92 D.T.C. 2365(T.C.C.), Judge Bowman of the Tax Court of Canada stated that:

"For a corporation to be operated for the purpose of earning a profit so as to qualify it for the exemption of paragraph 149(1)(l), it will be necessary that it do more than merely earn passive income. The earnings of such income would need to be both an operating motivation of the fund and a focus of its activity".

A copy of Interpretation Bulletin IT-496 is available on the Revenue Canada Web Site (N.B. <http://www.rc.gc.ca/menu/EmenuZZZ.html>).

**c) Reporting Requirements**

As mentioned before, there is no general reporting requirement for non-profit organizations; however, larger organizations must file a T1044 return pursuant to subsection 149(12). If the organization is a corporation, the provisions of subsection 150(1) will require that an annual tax return be filed. Where a non-profit organization has failed to file the appropriate returns, the situation can be cleared up by making a "voluntary disclosure" to the groups District Tax Office. If other statutory requirements have been met, the Revenue Canada department is usually satisfied by the filing of returns and financial statements for the previous five to seven years.

#### **IV. Associated Organizations**

The only relationship between two separate charities which is specifically recognized by the ITA is the category of associated charities (N.B. section 149.1(7) of the ITA). Two or more charities may apply to the Minister to be considered associated charities. This provision was set up to allow the charities to deal with the problem that charitable organizations are not normally allowed to transfer more than 50% of their income to other qualified donees. That is to say, the main benefit which flows from two or more charities being associated is that the 50% rule becomes inapplicable, and up to 100% of funds can be transferred between such charities.

Another common type of "association" is between charities and non-profit organizations.

Where the non-profit organization is able to generate and accumulate income, that entity will be able to transfer that income to the associated charity.

It should be noted that these rules are currently in a state of flux. While the statutory rules are in place, it is almost certain that administrative practices will develop to further clarify these provisions. It may be that charities which are now using non-profit organizations to carry on activities which are not charitable should wait until the new rules become clearer before terminating existing arrangements where a successful arrangement has been achieved.

#### **V. De-registration and Cessation**

Having looked at the question of how a charity qualifies to be a charitable organization, we can now turn to the issue of the circumstances under which charitable organization can be de-registered.

Section 149.1 of the ITA provides three primary basis for de-registration.

1. Under paragraph 149.1(2)(a), registration of a charity can be revoked for carrying on an unrelated business;
2. Under paragraph 149.1(2)(b), registration can be revoked if it fails to meet its annual disbursement quota; and
3. Subsection 149.1(4.1) makes de-registration the penalty if the charity makes a gift to another charity where the purpose of the gift was to unduly delay the expenditure of funds on charitable activities and where the charities acted in concert.

In addition to the de-registration provisions of section 149.1, section 168(1) and (2) set out another series of offenses, the penalty for which is de-registration. These include:

- a) Where the charity applies to be de-registered;
- b) Where the charity ceases to meet the statutory requirements necessary for registration;
- c) Where the charity fails to file its various information returns;

- d) Where the charity improperly issues a receipt; or
- e) Where the charity fails to maintain proper books or is in contravention of legislation dealing with disclosure of information to Revenue Canada.<sup>4</sup>

Turning now to non-profit organizations. Given the earlier discussion of the status of non-profit organizations, it will be apparent that in many cases the loss of non-profit status will occur without any specific steps being taken. That is to say, if at any time an organization ceases to meet all of the requirements of paragraph 149(1)(l), it will cease to be a non-profit entity and will instead become taxable under some other provision of the ITA.

Moreover, it is possible that an organization can shift back and forth between being taxable and non-taxable, depending on the facts. If a taxable entity were to become a non-taxable one, Revenue Canada's position would be that there was a deemed disposition which would trigger a capital gain in the taxable corporation prior to it becoming non-taxable. As mentioned before, Revenue Canada is not able to keep a very close eye on non-profit organizations and that applies specifically in this regard.

## **VI. Conclusion**

The above information sets out the law and policy relating to the establishment and operation of a charity and a non-profit organization and further details the relationship between associations of various charitable and non-charitable entities. In addition, matters of compliance and de-registration and cessation are dealt with in a general sense to give the reader an idea of the framework within which the charity and non-profit organization operate.

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<sup>4</sup> That is, it fails to comply with or contravenes any provision of sections 230 - 231.5 of the ITA, inclusive.