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# At the Crossroads: New Ideas for Charity Finance in Canada

*In the face of fundraising challenges, charities need the flexibility to  
finance their non-profit activities through business income  
– in areas directly related to their charitable missions,  
and in areas that are not.*

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## THE STUDY IN BRIEF

Canada's charities are increasingly looking at ways to finance their non-profit activities through business income – in areas directly related to their charitable missions, and in areas that are not.

Current legislation limits public foundations and charitable organizations to operating businesses directly related to the charity's purpose. Private foundations may not operate businesses of any type. The Canada Revenue Agency's policy on related business provides effective guidance for organizations that run ancillary businesses – such as hospitals that run parking lots. However, the Canada Revenue Agency's regulations are of little help for organizations that aim to achieve charitable ends by raising revenue through businesses unrelated to their charitable purpose.

In this *Commentary*, we show how Canadian governments could allow all types of charities – including private foundations – to own and receive income from unrelated subsidiary businesses, while respecting the policy rationale that drives restrictions on charities that directly operate unrelated businesses.

To this end, Canadian governments should:

- Coordinate federal administration of the *Income Tax Act* with varying provincial agendas for social enterprise;
- Allow for-profit businesses to deduct up to 100 percent of their net income, when donated to a charity, up to the small business deduction limit; and,
- Allow private foundations to own 100 percent of the shares of an arm's-length corporation and provide seed capital to social enterprises.

In the face of changes in giving patterns and financing sources for the sector, charities need such flexibility to carry out their important missions.

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## Canada's charities are at a financial crossroads. With traditional revenue sources declining, charities are increasingly looking at ways to finance their non-profit activities through business income – both in areas directly related to their charitable missions, and in areas that are not.

These efforts include “social enterprises,” or social entrepreneurship which, for the purpose of this study, we define as the pursuit of business income to finance charities’ activities. However, charities looking to earn business income face legislative and structural hurdles. As policymakers contemplate proposals to allow for more such entrepreneurship in the pursuit of public benefit, it is helpful to understand the legal framework that currently defines the scope of charities’ business activities.

The *Income Tax Act* largely restricts charities from directly operating businesses unrelated to their charitable purpose. Advocates for the sector have called for the removal of restrictions on business income that charities can earn while maintaining their tax advantages (Canadian Task Force on Social Finance 2010). Some such advocates argue that any charity should be free to run businesses related and unrelated to its charitable purpose with all profits earned tax free, as long it directs all proceeds to its charitable mission. However, policymakers have expressed the concern that removing these restrictions could lead to unfair competition between for-profit businesses and tax-supported charities.

This *Commentary* evaluates the merits of easing or changing the restrictions on unrelated businesses to allow charities to become more self-funding, to offset a potential decline in government and philanthropic funding. We show how Canadian governments could allow all types of charities –

including private foundations – to own and receive income from unrelated subsidiary businesses, while respecting the policy rationale that drives restrictions on charities that directly operate unrelated businesses. Canadian governments should consider reforms to:

- Coordinate federal administration of the *Income Tax Act* with varying provincial agendas for social enterprise. Provincial changes to corporate regimes should be met with similarly motivated federal changes;
- Allow a charity of any type to own controlling interests of up to 100 percent of one or more unrelated businesses, provided that the businesses it controls have arm’s-length boards of directors. This would allow charity boards to focus on their charity operations, without additional business distractions. Further, an arm’s-length requirement for any charity’s unrelated business would reduce the concern that individuals may attempt to divert corporate income through their private foundations;
- Allow for-profit businesses, whether or not wholly owned by charities, to deduct donations to a charity of up to 100 percent of business profits, subject to the income threshold that defines a small business for tax purposes (currently \$500,000). The effective tax rate on small business income currently is so low as to make negligible the taxes otherwise due. Moreover, raising the limit on deductible donations from 75 percent to 100 percent of taxable income would reduce the compliance burden for most charities with unrelated business income;

**Table 1: Share of Non-Profit Sector Revenues From Sales of Goods and Services**

	Canada	US	Australia	United Kingdom
Share of Total Revenue (percent)	32	79	39	49
Tax Model for Unrelated Business	Community Economic Development/ Subsidiary Business	Unrelated Business Income Tax (UBIT)	Destination Test – Introducing UBIT	Community Interest Corporations/Limited Destination Test
Year of Data	2008	2008	2006-2007	2007-2008

Note: UK estimate includes membership fees associated with significant benefits. Membership fees excluded for other countries.

Sources: Authors' calculations from CANSIM Table 388-0001, Clark et al. (2010), Internal Revenue Service, and Australian Bureau of Statistics.

- Maintain the current limits on tax deductibility of charitable donations, from income above the small business limit, so as to blunt the threat of large businesses operating tax-free; and
- Allow charities to provide a limited amount of capital, or seed financing, to arm's-length subsidiaries or social enterprises.

### Trends in Charity Income

Canada's non-profit sector is largely prohibited from directly operating unrelated businesses, while the US taxes the unrelated business income that charities earn, and Australia and the United Kingdom currently allow charities, within limits, to directly operate unrelated businesses. Canada's non-profit sector lags these countries with respect to the share of sector-wide revenues that come from sales of goods and services, whether related or unrelated to charitable purposes (see Table 1). Revenues from sales of goods and services – which includes sales

and charges for goods and services both related and unrelated to a charity's purpose – constitute 32 percent of total charity revenues in Canada, but account for 79 percent of revenue in the US, 39 percent in Australia, and 49 percent in the United Kingdom.

Donations by individuals dropped slightly between 2008 and 2009 and by 13 percent between 2007 and 2008.<sup>1</sup> Thus, charities have been looking to other sources of financing apart from individual donors.

### The Premise of Social Enterprise

There is much discussion of social enterprise in the charitable sector and among government policymakers. While there is no consistent definition of the term, social enterprises are organizations that achieve social purposes – and potentially profit thereby.<sup>2</sup> These organizations may be charities, not-for-profits,<sup>3</sup> or even for-profit businesses. The premise for allowing these organizations to compete

1 CANSIM Table 111-0001.

2 According to Elson and Hall (2010), a common definition of a social enterprise is “a business venture, owned or operated by a non-profit organization that sells goods or provides services in the market for the purpose of creating a blended return on investment; financial, social, environmental, and cultural.”

3 As discussed in greater detail later in the paper, the primary difference between charities and not-for-profits is that not-for-profits are not able to issue charitable donation receipts. Neither is subject to income tax.

## Box 1: Community Economic Development Programs

Some business unrelated to a charity's objectives is allowed under the CRA's policy on Community Economic Development Programs. This policy recognises that certain economic and social goals may be interrelated and may be charitable where, for example, business activities benefit the poor or unemployable. However, the policy limits market activities to situations related to the charity's objectives. Under this policy, micro-finance, for example, may be charitable but is still a business activity, so charging profit-making interest is only possible under the usual related business rules. Similarly, running a business by hiring the (generally) unemployable is permissible only if running a business is not an end in and of itself.

in the market is that some social objectives may be cost-effectively achieved using market tools.

The desire to benefit from one's endeavours drives private markets. The desire to 'do good' motivates socially minded actors. Social enterprise works because the two are not mutually exclusive (or people are prepared to limit one of their motivations). Governments subsidize those who 'do good' because economic theory predicts that some of the goods and services they provide, such as relief of poverty, would not be sufficiently provided privately. However, this subsidy is contingent on those 'doing good' being charities.

### Current Canadian Charity Regime

Current legislation limits public foundations and charitable organizations in their operation of 'related businesses' but private foundations may not operate businesses of any type.<sup>4</sup> The

Canada Revenue Agency's (CRA) policy defines a related business as having a connection to the charity's objectives – one that it is a usual and necessary concomitant of core programs or an offshoot thereof, or a use of excess capacity.<sup>5</sup> The business must also be ancillary to the charity's purposes, in that it does not come to dominate the charity's activities, or be a Community Economic Development Program (see Box 1). Charities that violate these rules are subject to deregistration.<sup>6</sup> The intent of these laws is to ensure that charities do not a) engage in unfair competition with for-profit companies or b) fund losses in ventures unrelated to their objects. Both could be addressed within a more flexible policy framework.

In practice, the CRA allows charities to run businesses that have a connection to their objectives – such as a hospital running a parking lot, a museum running a gift shop or a university operating a bookstore.<sup>7</sup> However, charities may not

4 Foundations are a type of charity wherein at least 50 percent of the organization's activity is devoted to grant-making rather than charitable service provision. If more than 50 percent of a foundation's capital is provided by one individual, or a group of related individuals, the Canada Revenue Agency classifies it as a private foundation.

5 There are no restrictions on business run by a charity when the businesses are run entirely by volunteers.

6 Not-for-profits (as distinct from registered charities) are not allowed any form of intentional profit-making business activities.

7 The CRA's policy statement on the definition of related business is available at: <http://www.cra-arc.gc.ca/chrts-gvng/chrts/plcy/cps/cps-019-eng.html>.

Table 2: Tax and Regulation Rules of Non-Profit Structures in Canada

Incorporation Model	Tax Relief Available	Restriction on Operating Profit-earning Businesses	Restriction on Distributing Profit	Restrictions on Activities Considered 'Charitable'	Restriction on Ownership of Subsidiary Business and Remittance of Profits
For-profit Corporation	None	None	None	None	None
Not-for-profit Corporation	Federal and provincial corporate income tax	Cannot operate profit-earning business	N/A	Must be for social welfare, civic improvement, pleasure, recreation or any other purpose except profit	None – no tax credit or deduction for profits remitted from businesses owned by not-for-profit
Charity or Public Foundation	Federal and provincial corporate income tax, HST/GST	Major allowances: Must be related and subordinate to charitable purpose, unrelated business may be run by volunteers or employ 'unemployable' people	Cannot distribute profit	Must be in advancement of education, religion, relief of poverty or other areas courts deem charitable	None – business may deduct donations from taxable income up to 75 percent
Private Foundation	Federal and provincial corporate income tax, HST/GST	Cannot operate any related or unrelated business	Cannot distribute profit	Similar to charities and public foundations	May not, in total with non-arm's-length people, own more than 20 percent of a business

Source: Carter and Man (2008).

Note: This is not an exhaustive list of regulations and taxes.

operate businesses that are clearly unrelated to their purpose, unless operated by volunteers. A retail store run by paid employees is one possible example of an unrelated business.

In cases where individuals or corporations donate shares to a charity they control, there is an additional potential for abuse of the tax benefit. This concern – self-dealing by non-arm's-length people<sup>8</sup>

– has resulted in heightened regulatory scrutiny and restrictions on business ownership by private foundations. Private foundations, in total with non-arm's-length individuals, may not own more than 20 percent of any class of a private company's shares (see Table 2 for the restrictions on business operation and ownership by non-profit structure).

The reliance on administrative policy, as

8 These are people directly related to the directors of the private foundation.

opposed to legislation, by the CRA for a topic as potentially important as social enterprise may come as a surprise. Constitutional authority to regulate charities falls to Canada's provinces. However, the provinces have not exercised their authority in the area, and the federal government, through its authority to administer an income tax, has filled the gap. That said, the *Income Tax Act* contains a mere 38 words on the subject of related business, and leaves it to the CRA to provide administrative guidance for nearly all aspects of charity business income. This situation may be fortuitous, in that it is easier to change administrative policy than a statute.

For charities looking to rely on precedent, there is limited case law, with only three reported decisions on the topic. The first case, involving the Alberta Institute on Mental Retardation, allowed a charity to earn unrelated business income, so long as it was used for the charitable purposes of the organization – this is known as a destination test.<sup>9</sup> However, cases involving the Earth Fund and House of Holy God limited application of the Alberta Institute case to specific situations involving used clothing, and rejected the destination test.<sup>10</sup> The Earth Fund case is unhelpful because it rejected the related business test but did not clarify the meaning of a related business. In the final case involving the House of Holy God, the court ruled that the appellant's business was unrelated to its charity, based on the Earth Fund case and said no more. CRA policy is the only detailed guidance on the subject, and is the primary source of *de facto* law.

The CRA policy on related business provides effective guidance for organizations that run ancillary businesses – such as hospitals running parking lots – but it is of little help for

organizations that aim to achieve charitable ends through a clearly unrelated business.

As a matter of policy, business corporations have few restrictions on the types of businesses they may conduct, and they could conduct projects of a social enterprise nature. However, the income they apply to such projects is nonetheless taxable. One option for corporations with social aims, and who seek tax recognition for the profits they devote to them, is to pursue profit-making activities, and to donate the proceeds to a registered charity. Canadian tax-paying corporations are limited in their use of such deductions and are able to offset a maximum of 75 percent of taxable income.<sup>11</sup>

The businesses that charities own are subject to income tax, but deductions generated by their charitable donations reduce their tax payable, likewise subject to the 75 percent of income limit. In contemplating whether to lift that limit, as we discuss later, an important point is that combined federal and provincial small business tax rates, on income below \$500,000, range from 11 percent for a small business incorporated in Manitoba to 19 percent in Quebec (Table 3 and Hunter 2009). For the federal and provincial governments, lifting the 75 percent limit on unrelated businesses' donations, subject nonetheless to the small business limit, would imply foregone revenue of 25 percent of an already low percentage of taxable income, with those percentages in turn applying to a small share of total corporate income.

### *A Path Forward for Reform in the Canadian Constitutional Context*

While provinces have the constitutional authority to regulate charities, they do not exercise it. To

9 *Alberta Institute on Mental Retardation v. Canada* [1987] 3 F.C. 286, (1987) 76 N.R. 366, [1987] 2 C.T.C. 70, (1987) 87 DTC 5306 (F.C.A.).

10 *Earth Fund / Fond pour la Terre v. MNR* (2002), [2003] 2 CTC 10 (Eng.) (Fed. C.A.), *House of Holy God v. Attorney General of Canada* 2009 FCA 148.

11 *Income Tax Act*, R.S.C. 1985 c.1. (5th Supp.), s. 110.1.



**Table 3: Effective Tax Rates on Income Eligible for Small Business Deduction (Up to \$500,000)**

Province	Effective Tax Rate When 75 Percent or More of Net Income Donated	Statutory Small Business Tax Rate
Newfoundland	3.8	15.0
Prince Edward Island	3.0	12.0
Nova Scotia (Up to \$400k)	3.9	15.5
New Brunswick	4.0	16.0
Quebec	4.8	19.0
Ontario	3.9	15.6
Manitoba (Up to \$400k)	2.8	11.0
Saskatchewan	3.9	13.0
Alberta	3.5	14.0
British Columbia	3.4	13.5

Note: Tax rates are combined federal and provincial income tax rates using year-end 2011 rates.  
Source: Authors' calculations from Hunter (2009) and Ernst and Young (2011).

prevent a vacuum in regulation, the CRA acts as a regulator through its role as the taxing authority. The CRA's application of the *Income Tax Act* determines whether an organization is a registered charity, a not-for-profit or a taxable organization. Accordingly, although provinces might wish independently to implement significant charities tax policy changes, their success in doing so would be contingent on supportive federal action. For example, Ontario's recent repeal of the *Charitable Gifts Act* made it possible for charities to own more than 10 percent of a business (Mulholland et al. 2011), but the impact of this change is blunted by provisions in the federal act that restrict such shareholdings by private foundations.

### International Experience of Charities and Business Income

We next look at international models that are less

restrictive on charitable unrelated business activities than existing Canadian law; each model has drawbacks that policymakers should consider.

#### *England and Ireland*

England and Ireland use a destination test that allows any income earned by a charity's business activities to remain tax-free so long as it is applied to the charity's purposes. Unrelated business income may contribute up to 25 percent of the charity's total income. Charities may also own taxable subsidiaries, businesses not subject to these limits, where the businesses remit profits tax-free, because they claim the equivalent of donation tax support through a program known as Gift Aid.<sup>12</sup>

The intent of the destination test is to tax an organization that does not apply unrelated business income towards its charitable purpose.<sup>13</sup> However, by allowing charities to operate a business within

12 Unlike Canadian tax deductions that apply towards the donee's tax liability, the UK Gift Aid program provides the equivalent value of the donee's tax credit directly to the charity.

13 Given the Federal Court of Appeal decisions in the cases of Earth Fund and the House of Holy God, it is clear that the federal government would need to implement legislative changes to the *Income Tax Act* to institute the destination test.

a single corporate structure, the destination test potentially allows charities to finance money-losing businesses with tax-receipted donations, with the implication that taxpayers may find themselves supporting activities that are non-economical.

### *Australia*

The federal tax system in Australia applies a destination test similar to that in England and Ireland. However, in a May 2011 consultation paper, Australia began the process of limiting the scope of unrelated business income that is exempt from taxation (Australia 2011a).<sup>14</sup> Charities will still be able to operate unrelated businesses directly, but income not directed back to their charitable purpose would be subject to an unrelated business tax, while related income will remain free from tax. The intent of these reforms is to ensure that tax concessions to charities – which are more substantial in Australia than in Canada – are not provided to organizations that run purely commercial businesses (Australia 2011b).

### *United States*

The US federal income tax applies to charity income that comes from unrelated businesses. However, the Internal Revenue Service may remove charitable status for charities whose unrelated income represents more than 50 percent of income. Cordes and Weisbrod (1998) find that charities with taxable unrelated business income are adept at shifting joint expenses to reduce, and in most cases, eliminate their taxable income, which masks their true profitability (Sinitsyn and Weisbrod 2008). Because of the ability of charities to shift expenses

and revenues between taxable and non-taxable status within a single entity, this approach seems unwise for Canada.

### **Exotic or Indigenous Plants for the Canadian Charity Garden?**

Notwithstanding the merits of foreign structures, the situation in Canada calls for a homegrown solution that fits the Canadian tax regime and constitutional circumstances. The tools for allowing charities to increase their income through business activities already exist, and no new corporate structure is necessary to allow charities to operate unrelated businesses through subsidiaries. A new system that allowed more flexibility in the use of market tools, while respecting the policy objectives of existing restrictions, would require a re-evaluation of:

1. The overlap between federal and provincial priorities and jurisdiction;
2. The limitations on corporations' ability to benefit from deductions to charity;
3. Limitations on charities' ability to provide capital to startup businesses; and
4. Corporate accountability, such as corporate board membership and arm's-length rules.

### *Federal and Provincial Overlap*

The first area of concern relates to the tension between provincial goals and jurisdictions and the regulation of charities under the *Income Tax Act*. The constitution clearly allocates jurisdiction over charities to the provinces, but as the provinces have

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14 Sales by charities to governments are an area where charities and non-profits are especially in competition. The Australian Productivity Commission (2010) suggested the government review the practicality of the government adding an additional charge to charities competing alongside private providers to provide goods and services to the government to remove the tax advantage that charities have relative to private providers.

in practice, and for the most part, abandoned their authority in the area, the federal government has legislated a regulatory regime under the *Income Tax Act*. Consequently, independent provincial attempts to allow for greater social enterprise will always be stymied by federal dominance over the income tax – primarily in the charity sphere.<sup>15</sup> Some form of greater co-operation is clearly necessary, although beyond the scope of this paper.<sup>16</sup>

### *Donation Deduction Limits*

The second area of concern is the limitation on the amount of the deduction available to donors. The effective tax rate, in any of the provinces, for small business corporations' first \$500,000 in income, if they donate to charity 75 percent or more of income, is between 2 and 5 percent, a low figure (Table 3 and Hunter 2009). Removing the deduction limit on this income would reduce the tax take on earnings that would otherwise be available for charitable purposes.

Charities' small business operations face relatively low corporate income tax rate, and therefore contribute a small share of total government corporate income tax. In the United States, for the 2008 income tax year, of charities that filed an unrelated business income tax return, those that collected less than \$500,000 in gross unrelated business income were 93 percent of all filers. However, these 93 percent of charities collected approximately 21 percent of sector-wide gross unrelated business income and paid 20 percent of the total unrelated business income tax. Thus,

7 percent of charities earned the majority of unrelated business income and paid the majority of taxes.<sup>17</sup>

To ensure charitable unrelated businesses do not grow to sizes that substantially impair government tax revenue, a limitation, or a graduated limitation, on the deductions from income that charitable donations generate should remain in place for firms whose income is above the small business limit.<sup>18</sup> Business units of charities that retain earnings for future growth would find that this income would be taxable, ensuring a level playing field with other businesses that retain earnings for future growth.

### *Charities and Seed Financing*

One of the concerns surrounding the prospect of charities directly earning unrelated business income is the spectre of tax-supported donations subsidizing unprofitable businesses. This would be, among other things, economically wasteful. The usual route around the problem, underpinning current law and the discussion here, is to arrange for the unrelated income to be earned by an arm's-length entity, which in turn donates the income to charity. In our recommendations above, we suggest that the protection of an arm's-length board is sufficient to ensure that the unrelated, for-profit businesses that charities might directly operate are managed appropriately.

However, charities and private foundations also seek to launch innovative social enterprises that require seed capital, which typically would be provided by way of a long-term loan offered on forgiving terms. Current legislation limits private

15 The same might be said in reverse if the provinces choose to use corporate or trust legislation to pursue policy goals that differ from the federal government.

16 See Aptowitz (2009).

17 See <http://www.irs.gov/pub/irs-soi/08eo02ub.xls>.

18 We also point out that the current tax regime provides different tax rates for active business income, investment income and manufacturing and processing income. Given that the relatively low effective tax rates generated by the small business deduction apply only to active business income, the regime suggested here also should be limited to active business income.

foundations to providing below-market-rate loans to registered charities, and not to unrelated businesses (Philanthropic Foundations Canada 2011). Yet private foundations could be a significant source of seed funding for social enterprises. Accordingly, and similar to our recommendation above, which would allow private foundations to own for-profit businesses, we suggest that private foundations should also be allowed to provide loans to for-profit businesses.

Before extending this capacity to private foundations, policymakers should consider what limitations should apply. These include issues such as whether the term of a loan constitutes *de facto* ownership, what is the relationship of the foundation to the borrower, and what limits there might be on the dollar amount of loans.

By way of response to this concern, we refer to more conventional fundraising techniques that charities use. At their core, fundraising campaigns are similar to business activities which require capital investment (charity funds in this case), carrying the potential of requiring additional capital infusions and have various rates of risk and return.

Despite these risks, charities are not prohibited from undertaking fundraising campaigns. Rather, the CRA has put together some guidance on acceptable expenses for charities in the fundraising context. We suggest that there is room for flexibility in restricting the extent to which charities can provide capital to their subsidiary businesses, rather than simply outlawing such allocations. Again, and to prevent charities from pursuing one type of income source ahead of others, the CRA should apply the principles associated with its fundraising guidance to the rules on charities' provision of seed capital to subsidiary businesses.

### *Corporate Accountability, Focus and Compliance*

In addition, the use of separate corporations has the additional benefit of limiting the exposure of charitable assets to satisfy the claims of business creditors (Hunter 2009).<sup>19</sup> Another benefit of mandating the use of corporations is the ability to elect a separate board capable of running such a business. Directors of a charity are not necessarily capable of running a business. Neither can they be paid for their role as such.

On the other hand, directors running a business owned by an arm's-length charity can be held accountable for their actions while allowing the charity to focus on its usual activities. In fact, the arm's-length test is already used in a charity context to define an 'eligible donee'. Thus the concept of requiring the board of a subsidiary business corporation to act at an arm's length from the parent charity is understood within the sector. Moreover, an arm's-length requirement would remove the policy reasons against having a private foundation owning shares of a private corporation.

Any reform to the charitable operation of businesses will have to support the current policy goal of forbidding use of a charitable registration to escape corporate taxation. Additional audit requirements may be needed for charities that receive a large share of their income from a single business, or handful of businesses, that claim a large amount of donation tax credits relative to their income.

Charities currently file information returns outlining detailed expenses of their operations. Requiring charities to disclose the operations of wholly owned subsidiaries in a similar manner would present a better view of their operations.

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<sup>19</sup> The related benefit is the protection of the charity's reputation from certain industries. To be clear, we are not proposing any limitations on the types of businesses run by charities. Such artificial limitations are an unnecessary constraint on the judgment of the charities.

## CONCLUSIONS AND RECOMMENDATIONS

In the face of changes to financing sources for the sector, charities policy should change to balance the needs of competitive efficiency against the public benefit these entities perform.

With relatively simple changes, existing Canadian charity, not-for-profit and for-profit incorporation models may be the simplest and most direct route to enable the creation of social enterprises. Such reform should consider the following:

- The provinces should agree not to prohibit charities from owning shares of a private corporation. Such legislation existed until recently in Ontario when that province repealed the *Charitable Gifts Act*;
- Allow for-profit businesses to deduct 100 percent of profits donated to a charity up to the small business deduction limit; and,
- Allow private foundations to own 100 percent of the shares of an arm's-length corporation, provided the corporation is indeed arm's length from the charity, so that the risk of directors' self-dealing is minimized.

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