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EOTR
The Exempt Organization Tax Review

Volume 59, Number 2 ■ February 2008

News and Analysis

Special Reports

Viewpoint

Canadian Charity Law

Focus on the IRS

Public Benefit and Canadian Public Hospitals

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American state, federal, and municipal tax authorities have recently started to question the reasoning behind the tax-exempt status of nonprofit hospitals.[1] One of the issues at stake in the federal examination is whether hospitals are truly adhering to the regulatory standards set out by the IRS in Rev. Rul. 69-545, 1969-2 CB 117. That ruling links the tax-exempt status of hospitals with the goal of promoting health, with much focus on the use of surplus revenue to improve patient care, expand facilities, advance medical training, or provide education. Collectively this is often referred to as providing "community benefit."[2] The ambiguity of this provision has resulted in some controversy in that it has become difficult to assess whether public hospitals are in fact devoting their "profit" to community services and whether they are offering any benefit to the public, in particular to people without insurance.[3] This leads to the issue of whether there should be any difference in tax consequences between private for-profit hospitals and nonprofit hospitals.

The Canadian healthcare system is based on a system of public nonprofit charitable hospitals paid for largely by universal health insurance schemes. Although Canadian hospitals must actually benefit the public, the standard used to determine whether that is being done is what differs between the two countries: The United States looks to regulations while Canada relies on English common law. Canadian nonprofit hospitals have always been considered charitable entities (a status inherited from English law[4]), and as such, virtually all Canadian hospitals are registered charities capable of issuing charitable receipts for donations[5] and are exempt from federal income taxation.[6] This article will describe the current Canadian definition of charity (including the public benefit test) in the hospital context.

The Canadian Definition of Charity

Although the Income Tax Act (Canada) provides the legislative framework for the categorization, registration, and tax regulation of charities,[7] it does not contain a definition of charity. The actual definition of charity is based on and found in the common law. Canadian courts have adopted the English common law of charity, which in essence states that an organization is considered charitable if its purposes are exclusively and legally charitable and if its resources are devoted to charitable activities in furtherance of the charitable purpose. Also, to be considered charitable, an organization must be established for the benefit of the public, or at the very least a sufficiently large segment of the public.[8] To satisfy the first part of the analysis, the Canada Revenue Agency (the taxing authority that enforces the ITA) and the courts will assess whether the organization's charitable purposes fall within one of the four "heads of charity" defined by the English House of Lords in 1891 in *Commissioners of Income Tax v. Pemsel*.[9] The court in *Pemsel* set up a scheme of four classified heads under which recognized charitable purposes must fall: (1) the relief of poverty; (2) the advancement of education; (3) the advancement of religion; and (4) other purposes beneficial to the community as a whole not falling under any of the preceding heads. This last residual category relies on a list of charitable purposes set out in the preamble to the *Charitable Uses Act, 1601*,[10] commonly referred to as the *Statute of Elizabeth*, which in modern language generally provides as follows:

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[1]*See, for example*, C.M. Jedrey and K.F. Klanica, "How Should Non-Profit Hospitals Provide and Report Community Benefits?," *Taxation of Exempts*, May/June 2007 at 283.

[2]*Id.*

[3]*Id.*

[4]H. Picarda, *The Law and Practice Relating to Charities*, 3rd ed. (London: Butterworths, 1999) at 121.

[5]Under subsection 149.1 (1) of the Income Tax Act (Canada).

[6]Under paragraph 149(1)(f) of the Income Tax Act (Canada).

[7]Income Tax Act, R.S.C. 1985 (5th Supp.), c. 1, s. 149.1(1).

[8]*McGovern v. A.G.* (1981), [1982] 2 W.L.R. 222 (C.A.), [1982] 2 All E.R. 439.

[9][1891] A.C. 531 (H.L.).

[10]43 Eliz. I, c.4.

> . . . for relief of aged, impotent and poor people, some for maintenance of sick and maimed soldiers and mariners, schools of learning, free schools, and scholars in universities, some for repair of bridges, ports, havens, causeways, churches, sea-banks and highways, some for education of preferment of orphans, some for or towards relief, stock or maintenance for houses of correction, some for marriages of poor maids, some for supportation, aide and help of young tradesmen, handicraftsmen and persons decayed, and others for relief or redemption of prisoners or captives, and for aid or ease of any poor inhabitants concerning payments of fifteens, setting out soldiers, and other taxes.

Analogies are usually drawn between the list in the *Statute of Elizabeth* and proposed charitable activities to determine if an organization is considered charitable under the fourth head of charity. Hospitals fall within the fourth head of charity by analogy to the "maintenance of sick and maimed soldiers and mariners" category, a category that has been held to be analogous to the promotion of public health.[11]

The Public Benefit Requirement

Most charities fall within one of the first three heads of charity. As a matter of English common law, public benefit is a secondary overarching requirement that must be met by all charities, although it is presumed to be present for those charities falling within the first head (relief of poverty),[12] and it is applied less strictly for charities falling within the second head (supporting the advancement of religion).[13] Charities falling within the third and fourth heads (advancement of education and other purposes beneficial to the community) are required to show that the segment of the public that may benefit from the organization's activities will consist of a sufficiently large portion of the community. Common-law public benefit, like community benefit, is a difficult concept to define. Even if a purpose by its nature is advantageous to only a few people, as long as it is open to a sufficient segment of the community, it is held to be of public benefit.[14]

What comprises a sufficiently large segment of the community can vary depending on the head of charity under consideration. For example, as stated above, public benefit will be presumed under the first head (relief of poverty), and this has been held to be so even when the beneficiaries are the next of kin of the charity's founder.[15] However, when considering public benefit under the other heads, the courts have developed a rule of law, commonly referred to as the "personal nexus test," which is set out in *Re Compton*.[16] This rule will deny charitable status to an organization if the intended beneficiaries are connected to the organization by blood or by contract. In *Re Compton*, the court held that a trust for the education of the descendants of a testator was not charitable. Although the trust satisfied the first requirement in that it was set up for the advancement of education, it failed the public benefit test because the trust was set up to benefit members of the testator's family. The court thus held that the trust in question was merely a private family trust.

The Call for Reform

The most comprehensive analysis of charity law in Canada to date was released by the Ontario Law Reform Commission (OLRC) in 1997. *Report on The Law of Charities*[17] was part of the last report released by the commission, which was disbanded soon thereafter. The OLRC suggested that a real definition of charity should be developed to determine the efficacy of the common-law definition. However, instead of asking for statutory reform, the OLRC felt that the common-law definition should be retained and allowed to evolve. Any deficiencies in the definition could be addressed by the courts. The commission confirmed the first part of the *Compton* test in that there cannot be a personal relationship between the charity and its beneficiaries. However, the OLRC did not agree with the "class within a class" rule, and suggested that the size of the class of beneficiaries was not relevant.

Recent Canadian Case Law on the Meaning of Public Benefit

The most significant charities case to address the issue of the definition of charity and public benefit was the Supreme Court of Canada's decision *Vancouver Society of Immigrant and Visible Minority Women v. Minister of National Revenue*.[18] This was the first charity law case heard by the Court in more than 25 years. The Supreme Court also recently released a significant charity law decision in *A.Y.S.A. Amateur Youth Soccer Association v. Canada (Revenue Agency)*,[19] which essentially follows the reasoning set out in *Vancouver Society* regarding its discussion of public benefit. In *Vancouver Society*, the majority held that when an organization is seeking charitable status under the fourth head of charity, it is not enough that the organization pursue aims that are viewed as good or beneficial in some generic sense; the aims must be beneficial in the eyes of charity law. Recognizing that this reasoning is somewhat circular, the majority adopted the following test from *D'Aguiar v. Gayana Commissioner of Inland Revenue*:[20]

> [The Court] must first consider the trend of those decisions which have established certain objects as charitable under this heading, and ask whether, by reasonable extension or analogy, the instant case

[11] P. Luxton, *The Law of Charities* (London: Oxford University Press, 2001).
[12] *Id.* at 172.
[13] J.M. Warburton, D. Morris, and N.F. Riddle, *Tudor on Charities*, 9th ed. (London: Sweet and Maxwell, 2003) at 78.
[14] *Id.*
[15] *Isaac v. Defriez* (1754) Amb 595.
[16] [1945] Ch.123 [*Compton*].
[17] Ontario Law Reform Commission, 1996, "Report on Law of Charities."
[18] [1999] 1 S.C.R. 10, 2 C.T.C. 1 [*Vancouver Society*].
[19] 2007 SCC 42 [*A.Y.S.A.*].
[20] [1970] T.R. 31 at 33.

> may be considered to be in line with these. Secondly, it must examine certain accepted anomalies to see whether they fairly cover the objects under consideration. Thirdly — and this is really a cross-check upon the others — it must ask whether, consistently with the objects declared, the income and property in question can be applied for purposes clearly falling outside the scope of charity; if so, the argument for charity must fail.

The majority in *Vancouver Society* also discussed a possible new approach to defining charity based solely on whether a particular organization is performing a public benefit. In determining the existence of a public benefit, the court would rely on a series of questions to assess the organization. These questions could include whether the organization's activities are consistent with the Canadian Charter of Rights and Freedoms[21] and the Constitution,[22] whether the activities complement legislative goals, and whether the activities are of a type to which governmental spending is typically allocated. Vagueness and uncertainty in the activities would not automatically bar registration since "many activities that we consider charitable are by their very nature vague and uncertain."[23] In the end, the Court decided not to adopt the approach, concluding that such substantial changes to the definition of charity should be effected by the Canadian Parliament rather than by the courts.

Hospitals as 'Other Purposes Beneficial to the Community'

As mentioned above, hospitals fall within the fourth head of charity, other purposes beneficial to the community. Case law has held a hospital to be a charity even if it charges fees. In the Australian case of *Re Resch's Will Trusts*,[24] the English Privy Council assessed whether a private hospital that charged fees could still be considered a charity. Although hospitals are generally considered charitable, the court determined that there may be some hospitals, or categories of hospitals, that are not charitable institutions. One criterion that would disqualify a hospital from being charitable would be if it is carried on commercially with a view to making profits for private individuals, or if the benefits it provides are not available to the public or a sufficiently large segment of the public. The plaintiff in *Re Resch's Will Trusts* objected to the hospital's practice of charging fees and argued that the hospital was not providing a benefit to the public but only to those individuals with sufficient funds to pay for the hospital's services. However, the court held that the charitable purpose of the promotion of public health was not limited to the poor:

> In the present case, the element of public benefit is strongly present. It is not disputed that a need exists to provide accommodation and medical treatment in conditions of greater privacy and relaxation than would be possible in a general hospital and as a supplement to the facilities of a general hospital. This is what the private hospital does and it does so at, approximately, cost price. The service is needed by all, not only by the well-to-do. So far as its nature permits it is open to all: the charges are not low, but the evidence shows that it cannot be said that the poor are excluded: such exclusion as there is, is of some of the poor — namely, those who have (a) not contributed sufficiently to a medical benefit scheme or (b) need to stay longer in the hospital than their benefit will cover or (c) cannot get a reduction of or exemption from the charges. The general benefit to the community of such facilities results from the relief to the beds and medical staff of the general hospital, the availability of a particular type of nursing and treatment which supplements that provided by the general hospital and the benefit to the standard of medical care in the general hospital which arises from the juxtaposition of the two institutions.[25]

Thus as long as some of the poor can access the hospital's services and any profits it makes are not put toward private benefit, a private hospital will be considered charitable by those common law courts that, like Canadian courts, follow the traditional English definition of charity. In its "Guidelines for Registering a Charity: Meeting the Public Benefit Test," the CRA says charging fees does not itself offend the public benefit principle, although under some circumstances it may.[26] The CRA lists the following factors that are to be taken into account when determining whether the charging of fees is incompatible with public benefit:

> Charges should be reasonable in the circumstances and should typically aim at cost recovery.
>
> Exceptionally, charges may, if appropriate to the overall purposes of the charity, be set at a rate that generates a surplus to help fund the organization's charitable programs and activities for the benefit of the public.
>
> Any charge should not be set at a level that deters or excludes a substantial proportion of those served by the charity.
>
> The service provided should not in practice cater only to those who are financially well-off — it should be open to all potential beneficiaries.
>
> It should be clear that there is a sufficient general benefit to the community, directly or indirectly, from the existence of the service.

In the U.K., the common law of charity has now been codified in the Charities Act, 2006.[27] The U.K. Charities

[21]Schedule B, Constitution Act, 1982.
[22]Constitution Act, 1867.
[23]*Vancouver Society* at 197.
[24][1969] 1 A.C. 514 (PC) [*Re Resch*].

[25]*Id.* at 544.
[26]"Guidelines for Registering a Charity: Meeting the Public Benefit Test," CPS-024, Mar. 10, 2006, http://www.cra-arc.gc.ca/tax/charities/policy/cps/cps-024-e.html.
[27]Charities Act, 2006, (U.K.), 2006, c. 50; D. Rowell, "Fee-Charging Charities and Public Benefit," *Trust Quarterly Review*, Vol. 5, Issue 3, 2007.

Commission recently released its guidance on the meaning of public benefit.[28] The commission has identified four principles that indicate whether an organization provides a public benefit:

- there must be an identifiable benefit;
- benefit must be to the public or a section of the public;
- people on low incomes must be able to benefit; and
- any private benefit must be incidental.

Regarding the third indicator, the commission says charities can charge for their services, but if the charges are so high that they effectively exclude people on low incomes from benefiting, either because they cannot afford or do not have access to other funding to pay the fees, that is likely to affect public benefit.

The Canadian healthcare system is similar to that described in *Re Resch*, except that all hospitals are nonprofit and they all charge fees. The fees for most emergency and essential services are covered by the relevant provincial healthcare plans for most patients. Services that are not covered can be paid for by private health insurance, by the patient, or by some other governmental support, such as aid for the elderly, disabled, or those on social assistance. As set out in *Re Resch*, hospitals will not be considered charitable if they are operated for commercial purposes. This requirement has been extended to all charitable organizations in Canadian tax law through ITA section 149.1(1). For an organization to be registered as a Canadian charity, it must devote all of its resources to charitable activities carried on by the organization itself and there must not be any personal benefit to any proprietor, member, shareholder, trustee, or settler of the organization. Any nonprofit hospitals set up to serve private interests would not be charitable. For example, in the 1971 decision of the Ontario Supreme Court (as it then was) in *Windsor Medical Services Inc.*,[29] a nonprofit corporation was established before the introduction of universal medical insurance and designated to provide medical services. The corporation entered into agreements with members of the public, whereby in return for payment of a subscription premium, they became entitled to medical services. The medical services were provided by doctors who entered into an agreement with the corporation to provide services. The Court held that the corporation was not charitable because both parties were induced by self-interest to enter into the agreements. The Court held that the arrangement was beneficial to the subscriber because it protected him against further medical payment if sickness developed in his family and that it was advantageous to the doctors providing services because it relieved them of having to collect their accounts, and in some cases, it increased the size of their medical practices.

The second qualification identified in *Re Resch* is that a hospital must provide services that are accessible to all, if not necessarily used by all, members of the public. For Canadian courts, analysis of the public benefit a hospital provides to the community would include the two-part test set out in *Compton*. The first part of this test states that an organization will not be considered charitable if its beneficiaries are connected to the charity by blood or by contract. The second part requires that a sufficient portion of society must benefit from the services offered. On its face, this does not seem to be a problem given a hospital's status as a public institution. Canadian hospitals generally serve all individuals who come to them for treatment because, in the great majority of cases, provincial healthcare plans or private insurance carriers pay for most services.

Conclusion

The Canadian common-law public benefit test, as it relates to hospitals, sets a considerably lower bar than does the U.S. community benefit test. Canadian hospitals can and do charge for their services without jeopardizing their charitable status. Because almost all Canadian residents qualify for provincial health insurance, the charging of fees by hospitals does not prevent members of the public from accessing a particular hospital's services. Thus, it is much easier for a Canadian hospital to demonstrate that it is providing benefits to a sufficient segment of the public than it is for a hospital in the United States.

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[28]Consultation on Draft Public Benefit Guidance, Charity Commission (*available at* http://www.CharityCommission.gov.uk).

[29][1971] O.R. 141.