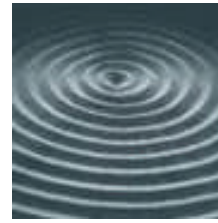
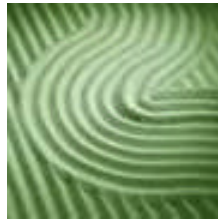


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## An updated introduction to the taxation of non-profit organizations Robert B. Hayhoe 2004

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8 Miller Thomson LLP 1998-2004

# An Updated Introduction To the Taxation of Nonprofit Organizations\*

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149. (1) No tax is payable under this Part on the taxable income of a person for a period when that person was...

Non-profit organizations

- (1) a club, society or association that, 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 was otherwise available for the 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; (*Income Tax Act*<sup>2</sup>)

## Introduction

This is an introductory outline of the taxation of nonprofit organizations. Although there have been good articles<sup>3</sup> published on the subject, they have, to varying degrees, been superseded by case law and by Interpretation Bulletin IT-496R *Non-Profit Organizations* issued by Canada Customs and Revenue Agency (CCRA) on August 2, 2001.

My descriptive approach to the subject will follow the order in which issues are raised by the *Income Tax Act* definition of “non-profit organization” in paragraph 149(1)(1) reproduced above. The specific items discussed will include the types of legal entities which can meet the definition, the requirement that the organization not be a charity, the requirement that the organization have a purpose other than profit, and the prohibition against paying income to members. Finally, the article will also discuss the rules applicable to the investment income of clubs and the filing requirements for nonprofit organizations.

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The theme of this article is a contention that the application of the paragraph 149(1)(l) definition is not entirely clear. As was observed by Walsh J., “the jurisprudence in this difficult area has led to varying results”.<sup>4</sup> Thus, my goal for this is the relatively modest one of summarizing the existing confusion, not synthesizing it into a logical structure.<sup>5</sup>

### **No Tax Payable**

As stated in the introductory portion of section 149, an organization which meets one of the tests in any of the paragraphs of subsection 149(1) is exempt from tax under “this Part”, i.e., Part I of the *Act* which imposes tax on income from a listed source. However, to the extent that other Parts of the *Act* could be read to impose a tax on a nonprofit organization, each of those Parts generally also contains independent exemptions from that Part for organizations which are exempt under section 149.<sup>6</sup> There is a similar exemption from Ontario corporate tax.<sup>7</sup>

### **Club, Society or Association**

The tax exemption for a nonprofit organization is available to “a club, society or association”. Although it might be possible to interpret “a club, society or association” in a restrictive manner, courts have not taken this approach.

Courts have accepted (with little discussion), that corporations,<sup>8</sup> unincorporated associations,<sup>9</sup> trusts<sup>10</sup> and other types of organizations where the nature of the legal personality of the organization is not even clear from the reported decisions<sup>11</sup> may all qualify as “a club, society or association”.

At one point, Revenue Canada<sup>12</sup> had made an assessment on the basis that a corporation with share capital could not be an “association”. The Exchequer Court rejected this argument in *St. Catharines Flying School Ltd. v. M.N.R.*,<sup>13</sup> pointing out that the then equivalent of paragraph 149(1)(l) made reference to a “stockholder” (now replaced by “shareholder”). CCRA now accepts that a corporation with share capital may qualify.<sup>14</sup>

An area where there was once some question is whether a trust could qualify as a nonprofit organization. In a number of older technical interpretations, Revenue Canada took the position that, since a trust must have a beneficiary, it could not meet the test in paragraph 149(1)(l) which requires that no portion of the income of the organization be payable to a member.<sup>15</sup> While some of these technical interpretations also mentioned in passing that there was some possibility of a purpose trust<sup>16</sup> meeting the requirements, it was suggested that this was rather unlikely.<sup>17</sup>

The issue of whether a trust can be a nonprofit organization was dealt with conclusively in *L.I.U.N.A. Local 27 v. The Queen*<sup>18</sup> where Bowman J., (as he then was) held that provided that a purpose trust otherwise met the qualifications in paragraph 149(1)(l), there was no reason why it should not be a

nonprofit organization. The particular trust at issue in that case was a purpose trust resident in Ontario with the purpose of supporting training for members of the Ottawa local of the Labourers International Union of North America (L.I.U.N.A.). Since only purpose trusts which are charitable are valid at common law, there was concern that the trust was not a valid one. However, Bowman J. decided, on the basis of section 16 of the *Perpetuities Act (Ontario)*,<sup>19</sup> that the training trust was a valid trust. Section 16 essentially provides that noncharitable purpose trusts are valid in Ontario, although they remain subject to the rule against perpetuities.<sup>20</sup>

The one type of entity which has not been considered in appropriate detail but where there is a potential difficulty in establishing tax exemption under paragraph 149(1)(l) is a partnership. Given that the definition of partnership in the *Partnership Act*<sup>21</sup> (Ontario) defines a partnership as “the relation that subsists between persons carrying on a business in common with a view to profit”,<sup>22</sup> it could be expected that there would be some difficulty in meeting the nonprofit purpose requirement in paragraph 149(1)(l).

Although I am aware of only one case which considers whether a partnership can be a nonprofit organization,<sup>23</sup> Revenue Canada certainly confirmed in at least one technical interpretation that it does not accept that a partnership can be a nonprofit organization: “all members of a partnership at common law, whether general or limited, carry on the partnership business”<sup>24</sup> and therefore share in the profit purpose of the partnership.<sup>25</sup> In *Bégin*, the Court concluded that a putative partnership formed to manage the orderly sale of liquor in a formerly dry Quebec town was a nonprofit organization. Although the Court considered the applicable Quebec *Civil Code* provisions dealing with partnership (which are said to require lucrative or profitmaking purposes), the Court appears to have based its decision on a theory that the partners of the alleged partnership could be viewed as trustees for various civic organizations. Since I am not a *Civil Code* lawyer, I am unable to comment on the correctness of this decision in its context. In a common law context, I would have expected that the decision would have been based upon the theory that the alleged partnership was actually an unincorporated association of the alleged partners.

It is certainly possible that an organization could describe itself as a partnership without being one.<sup>26</sup> It is my view that an organization which called itself a partnership but was not established with a view to a profit and which otherwise met the definition in paragraph 149(1)(l) could be viewed at law as “an association” and thereby could qualify for exemption.

### *Non-Residents*

Finally, unlike a registered charity,<sup>27</sup> a nonprofit organization need not be resident and established in Canada. Thus, it is possible for an organization which was not initially established in Canada to be exempt from tax pursuant to paragraph 149(1)(l).<sup>28</sup>

Foreign nonprofit organizations which are contemplating starting to operate in Canada need to consider carefully what structure is most advantageous. While there may be good reasons (like liability protection) for a foreign nonprofit organization to incorporate a separate sister organization in Canada, tax considerations might suggest that a branch operation would be preferable. To the extent that there is any desire to move money from the Canadian operations to the foreign nonprofit organization, the branch structure removes any concern that the distribution would be a prohibited member benefit.

### **Not a Charity**

A nonprofit organization must be, in the opinion of the Minister of National Revenue, not a charity.<sup>29</sup> What meaning is to be given to “in the opinion of”? Is this a requirement that an organization, prior to being accepted as a nonprofit organization, must have applied for registration as a registered charity and been denied on the basis that it is not charitable at law?<sup>30</sup>

This issue arose in the *L.I.U.N.A.* case<sup>31</sup> where no application for registration as a registered charity had ever been submitted and where no questions with respect to the Minister’s opinion had been asked by Appellant’s counsel at the examination for discovery. As a matter of pleading and litigation strategy, Bowman J. decided that since the opinion of the Minister was entirely within the purview of the Minister, the respondent (Revenue Canada) bore the onus of proof in this issue. Furthermore, Bowman J. stated that “in the absence of any evidence of the Minister’s opinion, it must be presumed that had he formed an opinion, he would have done so on a correct legal basis. If he was properly instructed as to the law, he would have concluded that the appellant was not a charity.”<sup>32</sup>

Thus, it appears that the test in subsection 149(1) requires only that an organization not be charitable at law in order to be a nonprofit organization; no specific prior consideration of the matter by the Minister of National Revenue is necessary.<sup>33</sup> However, if there is doubt about the status of an organization as an NPO or charity, an application for registration as a charity may still be in order.<sup>34</sup>

Bowman J.’s *L.I.U.N.A.* decision leaves open the question of what would be the effect if the Minister considered the issue and made an incorrect determination that an organization is a charity (when it would prefer nonprofit organization tax treatment). Presumably, the organization would be able to apply to the Federal Court for judicial review of the Minister’s decision.<sup>35</sup> Since the error would be one of law (misapplying the common law definition of charity), it is to be hoped that the Court would correct the Minister’s determination. (This article is not the appropriate forum for discussing what constitutes a charitable purpose at law<sup>36</sup> or analyzing the extensive jurisprudence dealing with this subject, e.g., *Vancouver Society of Immigrant and Visible Minority Women v. M.N.R.*<sup>37</sup>)

A question which arises from the above discussion concerns the tax treatment of an entity which is charitable at law but which is not a registered charity. Pursuant to paragraph 149(1)(f) of the *Income Tax Act*, a registered charity is exempt from Part I income tax. Registered charity is defined in section 248(1) as “a charitable organization, private foundation or public foundation ... *that has applied to the Minister in prescribed form for registration and that is at that time registered*” (emphasis added). If application has never been submitted by an organization for registration as a charity it is not entitled to take advantage of the exemption from Part I tax found in paragraph 149(1)(f).

Thus, an organization which is charitable at law but which is not a registered charity is not provided with any specific exemption from Part I income tax pursuant to the *Income Tax Act*. As a result, it is at least arguable that unregistered charities are taxable under the *Income Tax Act*.<sup>38</sup> How their income should be calculated is a matter which I will not discuss in detail at this time but it is possible that the income of an unregistered charity could include any annual surplus from operations or even all revenue.<sup>39</sup> There might be an argument that income from charitable operations is not income from a source which is taxable pursuant to Part I of the *Income Tax Act*.<sup>40</sup>

#### *Registration of Unregistered Charities*

In one sense, the obvious solution to this difficulty would be to apply to have an unregistered charity registered as a charity. While this would certainly involve additional record keeping requirements and Canada Customs and Revenue Agency filings, these issues should be manageable in most cases. However, subsection 149(10) provides that on a corporation becoming exempt pursuant to section 149 (which includes the paragraph dealing with the tax-exempt status of a registered charity), the organization is deemed to have disposed of all of its property for fair market value, thereby triggering a capital gain.

Note that there is no parallel provision for organizations which are not organized as corporations so there does not appear to be any deemed disposition upon a charitable trust or an unincorporated charitable association becoming exempt by being registered.<sup>41</sup> This conclusion is dependent on the conclusion that the registration of a charity does not result in a change in use of the charity's property which would be taxable under section 45. Since a charity must, by definition, devote all of its resources to charitable purposes both before (as a matter of trust law) and after (as a matter of both trust and tax law) registration, there is no change of purpose which could give rise to a section 45 disposition.

Relatively senior officials of the CCRA inform me that, as a matter of administration, subsection 149(10) may not often be applied at the time of the charitable registration of an existing corporation.<sup>41</sup> These officials were not willing or able to provide any assurances that subsection 149(10) would not be applied more frequently in future.

While I understand the reasons why a registered charity which grants donation receipts is required to be registered,<sup>43</sup> the policy reasons for treating an unregistered charity as a taxable entity because it has not registered are not clear. This is particularly so since a nonprofit organization (which by definition has objects which are less beneficial to the public at large than those of an unregistered charity) and which has similarly lax tax reporting requirements, is not taxable. An unregistered charity which disposes of its property should not be required to apply for a remission order<sup>44</sup> in order to avoid tax on the resulting capital gain.

### **Purposes**

The most vexing issue in dealing with the definition of a nonprofit organization is the question of what purposes are permissible. This is an area where the jurisprudence has evolved considerably in the past 15 years and where Revenue Canada's past interpretations are suspect because they are too restrictive in light of recent jurisprudence.<sup>45</sup> Unfortunately, while the law has evolved considerably, it has not evolved in a clear and consistent manner.<sup>46</sup>

The specific approved purposes of a nonprofit organization are "social welfare, civic improvement, pleasure or recreation or ... any other purpose except profit". While the CCRA in Interpretation Bulletin IT-496R *Non-Profit Organizations* deals in some detail in paragraphs 5 and 6 with the differences between these terms,<sup>47</sup> provided that the purpose is not charitable, the conclusion of commentators has traditionally been that any purpose other than profit will qualify, thus making all but the last item in the list effectively extraneous.<sup>48</sup> Thus, a nonprofit organization can be constituted for almost any purpose.<sup>50</sup>

It might be suggested that an organization which has one of the specific purposes listed in paragraph 149(1)(l) is not also required to have a purpose other than profit. This argument is not tenable given that paragraph 149.1(1)(l) requires that a nonprofit organization be "organized and operated *exclusively*" (emphasis added) for the qualifying purposes. This leaves no room for subsidiary purposes (which might be argued to include profit) tied to any of the listed purposes. However, as discussed below, organizations devoted to one of the listed purposes may have more freedom to have an actual profit without leading to the conclusion that a profit purpose exists than would an organization which has an unlisted purpose other than profit.

It is important to keep in mind that a nonprofit organization must be both organized and operated for a purpose other than profit. Being "organized" for a purpose other than profit is relatively simple, requiring only that the corporate objects and/or other statements of purpose of the organization are drafted such that profit-making is not a proper purpose for the organization. However, it is the second part of the requirement (that the organization *be operated* for a purpose other than profit), which continues to confuse and has given rise to recent litigation.

In Interpretation Bulletin IT-496R, the CCRA sets out its position on when an organization does and does not have a purpose other than profit:

7. It will be a question of fact to be determined with regard to the particular circumstances as to whether an association is carrying on a trade or business and if so, whether it will result in a finding that an association is not operated exclusively for nonprofit purposes. Some characteristics that might indicate that an activity is a trade or business are as follows:

- (a) it is a trade or business in the ordinary meaning, that is, it is operated in a normal commercial manner;
- (b) its goods or services are not restricted to members and their guests;
- (c) it is operated on a profit basis rather than a cost recovery basis; or
- (d) it is operated in competition with taxable entities carrying on the same trade or business.

Generally, the carrying on of a trade or business directly attributable to, or connected with, pursuing the nonprofit goals and activities of an association will not cause it to be considered to be operated for profit purposes.

8. An association may earn income in excess of its expenditures provided the requirements of the *Act* are met. The excess may result from the activity for which it was organized or from some other activity. However, if a material part of the excess is accumulated each year and the balance of accumulated excess at any time is greater than the association's reasonable needs to carry on its nonprofit activities (see paragraph 9), profit will be considered to be one of the purposes for which the association was operated. This will be particularly so where assets representing the accumulated excess are used for purposes unrelated to its objects such as the following:

- (a) long-term investments to produce property income;
- (b) enlarging or expanding facilities used for normal commercial operations; or
- (c) loans to members, shareholders or non-exempt persons.

This may also be the case where the accumulated excess is invested in a term deposit or guaranteed investment certificate that is regularly renewed within a year and from year to year, whether or not the principal is adjusted from time to time.

As can be seen from paragraph 7 reproduced above, CCRA primarily addresses this issue by looking at whether an organization carries on a business (with the implication that if it carries on a business, it cannot be a nonprofit organization). This approach to this issue is overly simplistic. The issue is not whether the organization carries on a business but whether the *purpose* of the organization and of its business activity is a purpose other than profit.<sup>51</sup> The existence of a business may be indicated by a reasonable *expectation* of profit,<sup>52</sup> but is not necessarily inconsistent with a *purpose* other than profit. Expectation is not purpose.



Similarly, in paragraph 8 of IT-496R, the CCRA has developed an asset accumulation test which suggests that if an organization accumulates assets in excess of its immediate needs, then it has a profit-making purpose. There is no statutory basis whatsoever for this test.<sup>53</sup> Indeed, one could argue that there is a statutory imperative requiring asset accumulation in some cases, given the prohibition in paragraph 149(1)(l) against distributions of income to proprietors, members or shareholders.

At best, the accumulation of assets in excess of immediate need by an organization should constitute only the most tenuous of evidence that the organization is being operated for profit.<sup>54</sup> An organization could easily have the purpose of making a profit without ever accumulating any assets while another organization could (as seen by the reported cases<sup>55</sup>) accumulate substantial assets without the intention or purpose of making a profit. Although CCRA has not been successful in raising assessments against nonprofit organizations on the basis of asset accumulation, it is unfortunate that the courts have paid lip service to this position of CCRA in IT-496R and its predecessor IT-496.<sup>56</sup>

The following summary of relevant cases may permit better understanding of the questions (if not the answers) which arise in determining whether an organization has a purpose other than profit.

In *Comptoir de Roberval v. M.N.R.*,<sup>57</sup> the citizens of a Quebec town decided to deal with the sale of alcohol by incorporating a company with share capital which would sell alcohol but which would transfer all profits made by the company to a charitable organization. The Tax Appeal Board reluctantly decided that this corporation with share capital (which had objects which clearly described the activities of the corporation as a business) was indeed operated for profit. The fact that the profit was required to be transferred to a charitable organization did not make it any less a profit. However, in *M.N.R. v. Bégin*,<sup>58</sup> another Quebec town arranged for the formation of a partnership<sup>59</sup> to sell beer. In this case, the partnership agreement made it clear that all partnership profits were to be used for charitable and nonprofit purposes and that if the partnership was dissolved all assets had to be distributed for charitable purposes. This case appears to have been decided in favour of the taxpayer on the ground that since he had no claim as (partner) to any of the income derived from beer sales, he should not be taxed on it.

In *Gull Bay Development Corporation*,<sup>60</sup> the Court decided that a share capital corporation which carried on logging operations in addition to various social activities was both a charitable organization and a nonprofit organization<sup>61</sup> because, while it appeared to carry on a business, the purpose of the apparently business-like activities was not the earning of a profit but was rather the social purpose of providing services and employment to disadvantaged native Canadians. It was pointed out that the Corporate Objects of Gull Bay Development Corporation all referred to charitable and social service activities and not to a

logging business. As the Court stated: “the social and welfare activities of Plaintiff are not a cloak to avoid payment of taxation on a commercial enterprise but are the real objectives of the Corporation”.

The Court’s conclusion in the *Gull Bay* case is consistent with the theory that profitable activities are less objectionable when linked to a specific listed purpose. After all, if the purpose is clearly a nonprofit purpose as listed in paragraph 149(1)(l), the existence of a profit is more likely to lead to the conclusion that any profit is incidental than if the purpose is not listed. If an organization seeks to qualify under paragraph 149(1)(l) as an organization operated for “any other purpose other than profit”, the existence of an actual profit raises more clearly, at least as a matter of evidence, the possibility of a profit purpose.

In *Tourbec (1979) Inc. v. M.N.R.*,<sup>62</sup> the Court held that a travel agency with approximately 75 per cent of sales to the general public and approximately 25 per cent on a subsidized basis to students, was not a nonprofit organization. The Court found on the facts of the case that the philanthropic aspect of the taxpayer’s business were only incidental to the primary purpose of operating a travel agency. The Court pointed out that “the Appellant’s philanthropic purpose or object could not have been achieved unless it had carried on a business which was a commercial operation for profit”. It is difficult to reconcile this decision with *Gull Bay*.

Revenue Canada refers, in a number of technical interpretations, to its requirement that there be “a clear distinct causal relationship between profit earning activities and the exempt purpose of the organization”.<sup>63</sup>

Revenue Canada also takes the view that a nonprofit organization may not simply engage in business activities and transfer money to another organization in order to carry out some nonprofit purpose: “in our view, the transfer of funds to another organization which carries on social welfare activities is not, itself, a social welfare activity of the transferor”.<sup>64</sup> In *Otineka Development Corporation Limited v. the Queen*,<sup>65</sup> the shares of the corporate taxpayer were owned by an Indian band. The Corporation in turn owned a shopping mall on the Reserve. While the taxpayer was successful on another ground,<sup>66</sup> the Court held that the Corporation was not a nonprofit organization. The decision was reached partly on the basis that the profit of the Appellant was paid on a regular basis to the Band as shareholder. The case was distinguished from *Gull Bay* on the ground that “here the corporations carried on commercial activities and distributed their funds to their shareholders” instead of carrying on civic activities directly.

Finally, in *The Canadian Bar Insurance Association v. The Queen*,<sup>67</sup> Mogan J. held that the Association was a nonprofit organization despite the fact that it carried on an active insurance business which was arguably in competition with insurance brokers or even insurers. Mogan J. based his decision on

extensive evidence which demonstrated that regardless of the actual surplus earned by the Association, its purpose (as confirmed by its corporate objects) was not profit. Mogan J. pointed out<sup>68</sup> that: “if the simple act of earning income from any source disqualified a person from relying on the exemption [paragraph 149(1)(l)], the exemption itself would be redundant and meaningless”. (As is, perhaps, acknowledged in CCRA document no. 2002-0153887 (19 August, 2002)). Furthermore, Mogan J. accepted that “the Appellant acknowledges that its particular activity is in an area populated by commercial enterprises (i.e., insurance companies) but the Appellant argues that that fact does not disqualify it from the exemption if its purpose was not profit making”. This was so despite the fact that the Association had built up a reserve of approximately \$25,000,000 by 1989.<sup>69</sup>

In a number of technical interpretations and in Interpretation Bulletin IT-496R, Revenue Canada has pointed out (sometimes with reasoning based on the difference between the *Gull Bay Development* and *Otineka* cases) that it will look more closely at a nonprofit organization which carries out commercial activities if the commercial activities are not related to the nonprofit purposes of the organization. For example, Revenue Canada stated that “although the revenues generated by the commercial operations might be used to fund the nonprofit activities of the organization, the organization itself cannot carry on a commercial operation which is not related to its nonprofit purposes and still be considered to be operating exclusively for a nonprofit purpose”.<sup>70</sup>

At the same time, Revenue Canada also admitted that “it is quite possible for an organization to make profits”.<sup>71</sup> That same interpretation goes on to state that “provided that the commercial operation is incidental to the attainment of the organization’s nonprofit objectives and all the revenues generated by the commercial operation are used to fund the nonprofit activities of the organization, the organization may carry on commercial operation and can still be considered to be operating exclusively for a nonprofit purpose”. CCRA has confirmed this approach more recently by stating that “an income-earning activity carried on by a club in the course of its authorized activities would not, generally, in and of itself, disqualify the club as a nonprofit organization”.<sup>72</sup>

Thus, while the cases and technical interpretations do not provide detailed rules, they do offer some guidelines. For example, a nonprofit organization must operate for a nonprofit purpose, however, in doing so, it may operate a business, provided that the purpose of the business is the achievement of a nonprofit end (beyond simply earning money to be applied to the nonprofit purpose<sup>73</sup>). It is my view (contrary to the CCRA position) that a nonprofit organization should be able to accumulate assets for its nonprofit purposes without any adverse inference being drawn.<sup>74</sup>

### **No Income Payable To Any Member**

The requirement that no income of the organization be payable to any member is deceptively simple. It is now clear that “income” in this paragraph of the *Act* refers to current year income not contributed capital or capitalized income.<sup>75</sup> Thus, it appears to be possible<sup>76</sup> for a nonprofit organization organized as a trust to operate at a surplus, capitalize that surplus and then distribute the capitalized surplus to its members.<sup>77</sup> This is supported (but not necessarily required) by subsection 149(2) which confirms that “income”, for the purpose of paragraph 149(1)(l) does not include capital gains.

Another issue which has arisen in this area is to what extent one looks to future possibilities in determining whether income is payable to a member. For example, the charters of some nonprofit organizations provide that, upon dissolution, the assets of the organization are to be distributed at the discretion of the directors or trustees. In such a situation, the Crown has argued that this discretion would permit a distribution of income to the members of the organization or even make available such income to members so that it cannot be a nonprofit organization.<sup>78</sup> The courts have held that, since the test for a nonprofit organization is applied on a year-by-year basis, the time for considering the application of the dissolution provisions is in the year of actual dissolution.<sup>79</sup> However, the belief that it would be possible on the same basis to establish a nonprofit organization which explicitly permitted the payment of income to members on a continuing basis is not justified, given that paragraph 149(1)(l) refers to “income...payable to or *otherwise available* (emphasis added) for...any member.”<sup>80</sup> While income which cannot be paid until dissolution may not be available in a year (in which no dissolution occurs), income which can be paid at will could be considered to be available in the year.

Turning from the obvious issues which arise from a cash payment to a member or shareholder of a nonprofit organization to the more difficult cases of member benefit, there exists a great deal of uncertainty. CCRA has considered a number of specific types of member services and concluded that these are not benefits of a type which is prohibited by the definition. For example, paragraph 12 of Interpretation Bulletin IT-496R specifically permits a nonprofit organization to pay to send its members to conventions and to pay salaries to them for services rendered and expenses for them.<sup>81</sup> Presumably, the basis for this distinction is that the payment is not a benefit received by the member in a personal capacity but rather is designed to further the purposes of the organization (which, in the case of a trade association, could include enhancing the trade or business of all members).<sup>82</sup>

On the other hand, Revenue Canada technical interpretations have concluded that the definition of a nonprofit organization “does not contemplate aid and assistance to a member in the carrying on of its business activities”.<sup>83</sup> Since trade associations are nonprofit organizations, care should be taken to ensure that payments do not assist members in carrying on their businesses but rather

that they act for the benefit of the industry as a whole. Where an action is taken that benefits the whole industry but also provides a specific benefit to a particular member (e.g., the sponsorship of test-case litigation), care should be taken to document the rationale for the action in terms of the interests of the industry as a whole.

Given that there could be issues surrounding the receipt of benefits by members for some nonprofit organizations, organizations which provide services to their members should consider instituting accounting systems which allow them to provide any services which arguably provide member benefit, out of the capital of the organization, leaving other expenses to be paid out of the annual income. This is easy in the context of a nonprofit organization organized as a trust (since trusts can capitalize their incomes), but may be of limited use for a nonprofit organization established as a corporation.<sup>84</sup>

### **Investment Income of Clubs**

Subsection 149(5) deems a taxable trust to exist when a nonprofit organization which has as its main purpose the provision of dining, recreational or sporting facilities for its members, earns property income. The deemed trust is limited to the extent of that property income. Few issues seem to have arisen with respect to whether a particular organization is a dining, recreational or sporting organization. Rather, the cases which have considered subsection 149(5) have all dealt with whether particular sorts of income earned by a club qualify as income from property.

Two Federal Court of Appeal decisions suggest that items of income which would be characterized as income from property in the hands of an individual generally keep that same characterization in the hands of a nonprofit organization. The most important of the reported decisions is *Elmridge Country Club Inc. v. The Queen*.<sup>85</sup>

In that case, a country club which collected its membership fees at the beginning of the year, invested the membership fees in short-term interest-bearing securities which were drawn down throughout the year to pay for the operation of the club. Although it was argued that the interest income on the short-term investments was really business income because it was incidental to the operation of the club, the Federal Court of Appeal refused to accept this distinction. It came to this conclusion on the basis of its misunderstanding of whether or not a nonprofit organization could earn income from a business, deciding that since, in its view, by definition, a nonprofit organization could not earn business income, the interest income must therefore necessarily be property income. To add insult to injury, to the extent that Elmridge had incurred interest expenses with respect to its short-term investment program, these interest expenses were not even held to be deductible.<sup>86</sup>

At least one commentator has suggested that the Federal Court of Appeal's approach is not justified, stating that "there is no reason in principle why the theory that was developed to resolve those cases [dealing with the distinction between income from property and income from business] cannot be applied to an organization that may have income from an undertaking organized and operated in a business-like fashion but for a purpose other than profit".<sup>87</sup>

### **Reporting Requirements**

If a nonprofit organization which is either a Canadian resident or which carries on a business in Canada is organized as a corporation, then it is required by the *Income Tax Act* to file an income tax return.<sup>88</sup> This return would indicate that the corporation is a nonprofit organization.<sup>89</sup> CCRA also has the power to demand from any taxpayer, whether or not the person is liable to pay tax, a full income tax return.<sup>90</sup> This power could be used by the Agency to require nonprofit organizations which are not corporations to file tax returns.

As well as these filing requirements which are of general application, subsection 149(12) requires all nonprofit organizations which have property income (interest, rental income or royalties) in excess of \$10,000 during a year (or any previous year) or which have assets (calculated in accordance with Generally Accepted Accounting Principles) in excess of \$200,000 to file a T1044 information return. This two-page form<sup>91</sup> includes a financial summary as well as a brief outline of the organization's activities.<sup>92</sup> Finally, a nonprofit organization which provides dining, recreational or sporting facilities and which is therefore taxable as a deemed trust pursuant to subsection 149(5) would be required to file a T3 trust tax return if it had certain types of income.<sup>93</sup>

### **Conclusion**

The above outline should make it clear that there are a number of issues arising from the definition of a nonprofit organization which remain unclear. While this uncertainty may not be such a bad thing for some organizations which can afford to take risks and obtain regular detailed professional advice,<sup>94</sup> it is not a suitable tax environment for most nonprofit organizations. The current 149(1)(l) should be replaced with a more detailed and logical structure. Knechtel<sup>95</sup> suggests that a replacement for 149(1)(l), while badly needed, should wait until the policy considerations behind tax exemption for nonprofit organizations and other entities have been considered. While this ambitious goal is laudable, I would still welcome amendments to clarify 149(1)(l) in the absence of a complete policy justification for all of the details. Even if a tax system has unclear basic premises, there is still value in internal clarity and consistency.

### **FOOTNOTES**

1. The author wishes to thank Gerald D. Courage of Miller Thomson LLP for his very helpful comments on earlier versions of this article.

2. *Income Tax Act* (Canada), R.S.C. 1985, c.1.1. (5<sup>th</sup> Supplement) (the *Act*). Statutory references are references to the *Act* unless otherwise noted.
3. See Ronald C. Knechtel, "Tax Treatment of Non-Profit Organizations" in *Report of Proceedings of the Forty-First Tax Conference*, 1990 Conference Report (Toronto: Canadian Tax Foundation, 1991), 35:1, at 35:16; Arthur Drache, "Charities, Non-Profits and Business Activities", *Report of Proceedings of the 49<sup>th</sup> Tax Conference*, 1997 Tax Conference (Toronto: Canadian Tax Foundation, 1998), 30; and Arthur Drache, *Canadian Taxation of Charities and Donations* (Toronto: Carswell, looseleaf), at 15-1.
4. *The Gull Bay Development Corporation v. The Queen*, 84 D.T.C. 6040 (F.C.T.D.), at 6058.
5. Apparently, the Department of Finance and Revenue Canada considered a more formal system to regulate nonprofit organizations in the early 1990s (Arthur Drache, *supra*, looseleaf, footnote 3, at 15-1). Nothing seems to have come of the review.
6. For example, the Part I.3 large corporation tax is not applicable to corporations exempt under section 149 by virtue of paragraph 181.1(3)(c). Similarly, subsection 212(14) provides an exemption from Part XIII withholding tax which would otherwise be imposed on a nonprofit organization earning income from Canada as does 219(2)(c) from the Part XIV tax on nonresident corporations, while subsection 227(14) provides exemption from tax pursuant to Parts IV, IV.1, VI and VI.1. (See paragraph 2 of Interpretation Bulletin IT-496R *Non-Profit Organizations*.)
7. Paragraph 57(1)(b) of the *Corporations Tax Act*, R.S.O. 1990, c.C.40 exempts from Ontario corporate income tax:
 

a club, society or association that, in the opinion of the Minister, was not a charity within the meaning given to that expression by subsection 149.1(1) of the *Income Tax Act* (Canada) and that was organized and operated exclusively for social welfare, civic improvement, pleasure or recreation or for any other purpose except profit, which has not in the taxation year or in any previous taxation year distributed any part of its income to any proprietor, member or shareholder thereof, or appropriated any of its funds or property in any manner whatever to or for the 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.

Note the difference in the income distribution limitation.
8. *Supra*, footnote 4.
9. *Canadian Bar Insurance Association v. The Queen*, 99 D.T.C. 653 (T.C.C.). Query what the effect is of the reference in subsection 149(1) to the tax exemption being on the taxable income "of a person". While one could argue that an unincorporated association is not a person at law, such an approach would defeat the purpose of paragraph 149(1)(l).
10. *L.I.U.N.A. Local 27 v. M.N.R.*, 92 D.T.C. 2365 (T.C.C.).
11. *M.N.R. v. Bégin*, 62 D.T.C. 1099 (Ex. Ct.).
12. Note that Revenue Canada was replaced by the Canada Customs and Revenue Agency (CCRA) on November 1, 1999. Depending on the dates involved, this article will refer to either.
13. 53 D.T.C. 1232 (Ex. Ct.).
14. CCRA Interpretation Bulletin IT-496R *Non-Profit Organizations*.
15. For example, Revenue Canada document no. ACS8405 (1 September, 1989).

16. A trust for a noncharitable purpose which would not be a valid trust at common law as it would violate the rule against perpetuities. For a good discussion of the rule against perpetuities, see The Law Reform Commission for England and Wales, *The Rules Against Perpetuities And Excessive Accumulations* (London: 1998) online: The Law Commission for England and Wales <http://www.lawcom.gov.uk/library/lc251/lc251ind.htm> (last accessed May 22, 2001).
17. Revenue Canada document no. 9413795 (25 July, 1994).
18. *Supra*, footnote 10.
19. R.S.O. 1990, c. P.9.
20. 16. (1) A trust for a specific noncharitable purpose that creates no enforceable equitable interest in a specific person shall be construed as a power to appoint the income or the capital, as the case may be and, unless the trust is created for an illegal purpose or a purpose contrary to public policy, the trust is valid so long as and to the extent that it is exercised either by the original trustee or the trustee's successor, within a period of 21 years, despite the fact that the limitation creating the trust manifested an intention, either expressly or by implication, that the trust should or might continue for a period in excess of that period but, in the case of such a trust that is expressed to be of perpetual duration, the court may declare the limitation to be void if the court is of opinion that by so doing the result would more closely approximate the intention of the creator of the trust than the period of validity provided by this section.  
  
(2) To the extent that the income or capital of a trust for a specific noncharitable purpose is not fully expended within a period of 21 years, or within any annual or other recurring period within which the limitation creating the trust provided for the expenditure of all or a specified portion of the income or the capital, the person or persons, or the person's or persons' successors, who would have been entitled to the property comprised in the trust if the trust had been invalid from the time of its creation, are entitled to such unexpended income or capital (R.S.O. 1990, c. P.9, s. 16).
21. R.S.O. 1990, c.P.5.
22. *Ibid.*, section 2.
23. *Supra*, footnote 11.
24. Revenue Canada document no. OC90-378.379 (October 1, 1990).
25. Not to mention that partnerships distribute their incomes to their members.
26. Contrast the decisions of the Supreme Court of Canada in *Backman v. The Queen*, 2001 SCC 10 and in *Spire Freezers Ltd. v. The Queen*, 2001 SCC 11.
27. Subsection 248(1) "Registered Charity". See R.B. Hayhoe, "A Critical Description of the Canadian Tax Treatment of Cross-Border Charitable Giving and Activities" (2001), 49 *Canadian Tax Journal* 320, p. 322.
28. As implied by Revenue Canada document no. 99000495 (26 August, 1999) and as confirmed by CCRA document 2001-0095285 (21 November, 2001).
29. In reviewing older Canadian tax jurisprudence on nonprofit organizations, it is important to realize that prior to 1977 there was no requirement that a nonprofit organization not be a charity. Thus, some of the older jurisprudence should not be relied on in concluding that an organization which looks charitable can also be a nonprofit organization.



30. As was suggested by J.J. Coombs, *Charities and Charitable Donations* (Don Mills: CCH Canadian Limited, 1978), at paragraph 624.
31. *Supra*, footnote 10.
32. *Ibid.*
33. Note that the CCRA Rulings Directorate appears to refer the portion of nonprofit organization status rulings requests dealing with charitable status to the Charities Directorate for comment – for example, Revenue Canada document no. 9900495 (26 August, 1999). It should be noted that Interpretation Bulletin IT-496R lists one of the conditions for being a nonprofit organization as being “it is not a charity” instead of “it must not, *in the opinion of the Minister*, be a charity” (emphasis added) as the same condition was listed in the predecessor Interpretation Bulletin IT-496.
34. Knechtel, *supra*, footnote 3, 35:4.
35. Pursuant to section 18 of the *Federal Court Act*, R.S.C. 1985, c. F-7.
36. See *Pemsel v. Special Commissioners of Income Tax*, 3 T.C. 53, [1891] A.C. 531 [1891-94] All E.R. Rep. 28 (H.L.).
37. 99 D.T.C. 5034 (S.C.C.).
38. Revenue Canada Technical Interpretations have come to this conclusion on many occasions: Revenue Canada document no. 9333965 (26 April, 1994) and document no. 9305505 (15 June, 1993). Similarly, see Coombs, *supra*, footnote 30, at paragraph 624 or Knechtel, *supra*, footnote 3, at 35.3.
39. Would an unregistered charity be able to deduct its expenses, since they would arguably not have been incurred to earn income?
40. See *Schwartz v. Canada*, [1996] 1 S.C.R. 254.
41. *Supra*, Knechtel, footnote 3.
42. See also Drache, *supra*, footnote 3, looseleaf, at 15:20.
43. *Supra*, footnote 27, at 323–4.
44. Pursuant to section 23 of the *Financial Administration Act*, R.S.C. 1985, c. F-11. See H. Arnold Sherman and Jeffrey D. Sherman, “Income Tax Remission Orders: The Tax Planners’ Last Resort or The Ultimate Weapon?” (1986), 34 *C.T.J.* 801.
45. As has been noted by a number of commentators: Peter Ranson, “Doing Business with First Nations – Tax Issues: Part 2”, 1998 *British Columbia Tax Conference*, (Vancouver: Canadian Tax Foundation 1998), at 14; Arthur Drache “Charities, Non-Profits and Business Activities”, *supra*, footnote 3; John Unger, “Tax-Exempt Status for Non-Profit Organizations: The Case of Canadian Bar Insurance Association”, (2001) 4:2 *Charitable Thoughts* 5, at 9.
46. “The decided cases dealing with paragraph 149(1)(l) and its predecessor provisions have not provided clear guidelines with respect to the meaning of the word ‘profit’ as used in this context, or regarding which profits should escape tax under the paragraph”. Knechtel, *supra*, footnote 3, at 35:7-35:8.
47. *Ibid.*, at 35:4-35:5 (a more detailed consideration of the individual approved purposes).
48. Knechtel, footnote 3, p. 35:5; Drache, footnote 3, looseleaf, p. 15:14.
49. *Ibid.*, Drache, p. 15:12.

50. CCRA document no. 2002-0153887 (19 August, 2002).
51. Unger, *supra*, footnote 45, at 9.
52. The “reasonable expectation of profit” test having been reduced from its status as the conclusive test for the existence of a business to that of a mere factor to be considered (*Stewart v. The Queen*, 2002 D.T.C. 6969 (S.C.C.)).
53. Arthur Drache “Charities, Non-Profits, Business Activities” *supra*, footnote 3. Knechtel, *supra*, footnote 3, suggests at 35:10 that this approach is supported by the fact that the *Act* does not explicitly permit a nonprofit organization to build an endowment for its nonprofit purposes. With respect, the argument is circular – why should the absence of an explicit prohibition of endowment building by a nonprofit organization not indicate that asset accumulation is permitted?
54. In CCRA document 2002-0099665 ( 22 July, 2002) the CCRA accepts that the financial statement characterization of the accumulation may be important (“reserve” or “surplus”).
55. For example, *L.I.U.N.A.*, *supra*, footnote 10 and *Canadian Bar Insurance Association*, *supra*, footnote 9.
56. As in *L.I.U.N.A.*, *supra*, footnote 10.
57. 56 D.T.C. 5 (T.A.B.).
58. *Supra*, footnote 11.
59. See the discussion of whether a partnership can, on any principled basis, be a nonprofit organization *supra*, footnotes 18-22 and accompanying text.
60. *Supra*, footnote 4.
61. As discussed *supra*, footnote 29, prior to 1977 there was no requirement that a nonprofit organization not be a charity.
62. 88 D.T.C. 1442 (T.C.C.).
63. Revenue Canada document no. 9727005 (5 June, 1998); Revenue Canada document no. 9727005 (30 June, 1998); as well as Revenue Canada document no. DC90 263264 (3 December, 1994).
64. Revenue Canada document no. 9704605 (17 February, 1998). See also paragraph 3 of Interpretation Bulletin IT-496R *Non-Profit Organizations*.
65. 94 D.T.C. 1234 (T.C.C.).
66. The Court found that the Band which owned the corporation was equivalent to a Canadian municipality, such that the corporation was tax-exempt pursuant to paragraph 149(1)(d).
67. *Supra*, footnote 9.
68. As had others, including Knechtel at 35:5 (*supra*, footnote 3).
69. For a detailed discussion of this case, see Unger, *supra*, footnote 45.
70. Revenue Canada document no. OC90 378.379 (1 October, 1990).
71. Revenue Canada document no. AC74457 (11 January, 1990).
72. Document no. 2000-0020995 (27 June, 2000).
73. Unlike a charitable organization which is permitted by section 149.1 to carry on a “related business”.
74. As is perhaps acknowledged in CCRA document No. 2002-0153887 (19 August, 2002).

75. Subsection 149(2) and *L.I.U.N.A. Local 27, supra*, footnote 10 and *Cumba Co-operative Health Services v. M.N.R.*, 52 D.T.C. 253 (T.A.B.).
76. Lisa Goldstein, “Non-Profit Organizations Can Be Profitable” (1993), 41 *Canadian Tax Journal* 710.
77. Knechtel (*supra*, footnote 3) suggests at 35:13 that the decision of the Supreme Court of Canada in *Woodward’s Pension Society v. M.N.R.*, 62 D.T.C. 1002 supports the contrary conclusion. With respect, the decision seems to have been made on the basis that the society had a profit purpose.
78. *Moose Jaw Industrialization Fund Committee Limited v. M.N.R.*, 51 D.T.C. 325 (T.A.B.) and *L.I.U.N.A., supra*, footnote 10.
79. As accepted by CCRA in paragraph 3 of Interpretation Bulletin IT409 *Winding-Up of a Non-Profit Organization* and in paragraph 11 of Interpretation Bulletin IT0496R *Non-Profit Organizations* (unlike paragraph 11 of the predecessor Interpretation Bulletin, IT-496).
80. Especially given that CCRA has considered this issue and come to a contrary conclusion. CCRA document no. 2001-0081575 (6 July, 2001). Of course, this document also concluded that a power to distribute on dissolution would disqualify the organization – ignoring the *Moose Jaw (supra, footnote 75)* and *L.I.U.N.A. (supra, footnote 10)* cases.
81. Revenue Canada document no. 913012A (10 January, 1992) and CCRA document 2003-0000215 (19 February, 2003).
82. Knechtel, *supra*, footnote 3, p. 35:13 points out that otherwise there is no need for the benefit to be “personal”.
83. Revenue Canada document no. ACC9659 (13 September, 1990).
84. *Supra*, footnote 73.
85. 99 D.T.C. 5127 (F.C.A.).
86. As had been predicted by Knechtel, *supra*, footnote 3, at 35:17.
87. Lorne Green, “Taxation of Not-For-Profit Organizations: The Final Word” (1999), 47 *Canadian Tax Journal* 110.
88. Paragraph 150(1)(a). Note that registered charities are exempted from subsection 150(1) by subsection 150(1.1).
89. Drache, looseleaf, *supra*, footnote 3, pp. 15-18A.
90. Subsection 150(2).
91. Available on the Internet at <http://www.ccr-aadrc.gc.ca/E/pbg/tf/t1044eq/3180.pdf>.
92. The questions asked are: “Briefly describe the activities of your organization”; “Are any of the organization’s activities carried on outside of Canada?”; “If yes, please indicate where.”
93. See the subsection 150(1) list of circumstances in which an individual (a trust being an individual for this purpose) must file a tax return. See Knechtel (*supra*, footnote 3), at 35:19 for a more detailed discussion of tax return filing requirements for a deemed trust.
94. Arthur Drache, looseleaf, *supra*, footnote 3, 15-23, has observed that: “If there is a redeeming feature to this situation, it is that Revenue Canada itself is probably as confused about the proper resolution of some of these issues as are members of the private sector”.
95. Knechtel, *supra*, footnote 3, 35:19.