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Update on NPO Issues

By Karen J. Cooper, LL.B., LL.L., TEP

kcooper@carters.ca

1-866-388-9596

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TOLL FREE: 1-877-942-0001

Ottawa Toronto Mississauga Orangeville
www.carters.ca www.charitylaw.ca www.antiterrorismlaw.ca

OVERVIEW

- Maintaining NPO Status
- Audit Issues
- Recent CRA Interpretations
- NPO Risk Identification Project
- Other Exemptions
- Update on Corporate Law

MAINTAINING NPO STATUS

- The terms “non-profit” and “not-for-profit” (“NPOs”) are used interchangeably and generally refer to organizations whose profits are not passed on to their members
- This section provides an update on recent CRA views on the tax exempt status of NPOs, including
 - Capacity of NPOs to earn profits
 - Carrying on a trade or business through an NPO
 - Tax consequences of losing NPO tax exemption
- Recent CRA views create uncertainty for NPOs and limit their revenue-generating capacity

FOUR BASIC REQUIREMENTS FOR NPOs

- To qualify as an NPO, organization must meet all 4 criteria under paragraph 149(1)(l) of the ITA throughout any taxation year in order to maintain tax-exempt status
 1. Not be a charity
 2. Be organized exclusively for social welfare, civic improvement, pleasure, recreation or any other purpose except profit
 3. Be operated exclusively for social welfare, civic improvement, pleasure, recreation or any other purpose except profit
 4. Not distribute or otherwise make available for the personal benefit of a member any of its income

- It is a question of fact that can only be determined after a review of the purposes and activities of the NPO
- NPO status must generally be reviewed on a year by year basis
- It is possible for an organization to qualify for exemption as an NPO for a period shorter than its fiscal year
- Being incorporated as a not-for-profit under corporate legislation does not mean that the organization is an NPO for tax purposes
- See CRA *IT-496R, Non-Profit Organizations*
<http://www.cra-arc.gc.ca/E/pub/tp/it496r/README.html>

1. Must not be a charity
 - If CRA considers an organization to be a “charity” as defined in subsection 149.1(1), then it cannot qualify in that period as a tax-exempt NPO
 - No explicit opinion from CRA is required and no ruling would be issued because it is always a question of fact
 - If an NPO is denied charitable registration, this does not automatically mean that it is not a charity
 - An organization with exclusively charitable purposes does not qualify as an NPO, even if it is not a registered charity

2. Must be *organized* for non-profit purposes
 - NPOs must be organized exclusively for social welfare, civic improvement, pleasure, recreation or any other purpose except profit
 - NPOs may be established to further any purpose other than for a profit purpose, no requirement that an NPO must have a “benevolent” or “social” purpose
 - When determining the purpose for which an association was organized, the instruments creating the association will normally be reviewed, including letters patent, articles of incorporation, memoranda of agreement, by-laws, etc.
 - Rarely an issue

3. Must be *operated* for non-profit purposes
 - NPOs must in fact be *operated* exclusively for social welfare, civic improvement, pleasure, recreation or any other purpose except profit
 - This is the criteria that is the subject of the most uncertainty for NPOs
 - CRA is generally of the view that an NPO can engage in commercial activities and earn an unintentional profit, but if it would be unable to undertake its not-for-profit activities but for its profitable activities, the organization cannot be an NPO because it has a profit purpose

- Issues
 - Carrying on a trade or business
 - Accumulating surplus/reserves
 - Earning investment income
 - Carrying on a trade or business through a wholly owned subsidiary

- Document 2010-0380581I7 – summary of CRA’s view
 - NPOs must operate “exclusively” for purposes other than profit (incidental profits do not amount to a profit purpose)
 - May receive incidental profits through basic fundraising (lotteries, bake sales, chocolate bar sales, etc.) and soliciting gifts and grants
 - Can earn profits, but the profits should be incidental and arise from activities that are undertaken to meet the organization's not-for-profit objectives (“incidental profits”)

- Earning profits to fund not-for-profit objectives is not considered to be itself a not-for-profit objective (i.e., no destination test)
- Should fund capital projects and establish (reasonable) operating reserves from capital contributed by members, from gifts and grants, or from accumulated, incidental profits
- Capital contributions, gifts and grants, and incidental profits should generally be accumulated solely for use in the operations of the organization (including funding capital projects or setting up operating reserves) and should not be used to establish long-term reserves designed primarily to generate investment income

- Maintaining reasonable operating reserves or bank accounts required for ordinary operations will generally be considered to be an activity undertaken to meet the not-for-profit objectives of an organization - incidental income arising from these reserves or accounts will not affect the status of an organization
- May engage in limited fundraising activities involving games of chance (e.g., lotteries, draws), or sales of donated or inexpensive goods (e.g., bake sales or plant sales, chocolate bar sales)

- In determining whether an organization has any profit purpose, the activities of the organization must be reviewed both independently and in the context of the organization as a whole
- CRA gave the following examples of acceptable activities that result in incidental profit
 - Operation of a canteen at a hockey arena
 - Charging admission above direct cost for a children's concert (where the not-for-profit purpose of the organization was to organize and promote youth participation in music)

4. Must not distribute income to members
 - An NPO must not distribute or otherwise make available for the personal benefit of a member any of its income unless the member is a RCAA
 - No part of the income of an NPO, whether current or accumulated, can be paid to a member, nor may it declare and pay dividends out of income
 - An NPO may fail to comply with this requirement on a winding-up, dissolution, or amalgamation resulting in tax liability
 - Certain types of payments will not, in and by themselves, disqualify an NPO, such as reasonable salaries, wages, fees or honorariums for services rendered to the NPO

CONSEQUENCES OF LOSING NPO STATUS

- Automatically becomes a taxable entity
- A deemed year end for the corporation is created and corporation deemed to have disposed of and reacquired all of the corporation's assets for fair market value [paragraph 149(10) if the ITA]
- It also affects the corporation's ability to carry forward losses and other balances or reserves
- Members of an unincorporated NPO would become responsible for any taxable income in the organization (CRA Document 2010-036970)
- Document 2010-035583 provides a recent discussion

RECENT CRA INTERPRETATIONS

- CRA View 2011-0392841E5 addressed whether an NPO can maintain its 149(1)(I) status while trying to recover its losses and continue to meet its objectives
- NPOs may:
 - Require higher member contributions to cover a previous years losses would not be a for-profit purpose
 - Is for improving a loss position, not generating investment income
 - Have members provide loans to NPO without loan repayments being considered income from the NPO being payable to the members
 - Question of fact whether member receiving payment in capacity of a lender or member

- Generating income to cover interest on loan will not indicate that NPO has a profit purpose
 - An expense to be taken into account
- Principal portion of loan should be paid from member contributions and incidental profits (or gifts and grants from other sources)
- Generating material profits from a particular activity in order to offset prior years' losses related to that activity would not be considered a profit purpose
- Cannot use profits from one activity to cover the expenses of another activity
 - “destination of funds” test has been rejected multiple times by the courts

- Carry on a business for profit and may remain non-taxable if it meets the requirements of paragraph 149(1)(I)
 - Leasing activities may be acceptable if they are connected to the objectives of the NPO
 - Question of fact
 - Incidental profits from the activities could be used to offset losses or expenses from other activities or to repay loans
 - Operation of a canteen at a hockey arena that results in incidental profit would be acceptable
 - But an NPO's business activities cannot be designed to be a driving force of the entity's existence and cannot be the NPO's principle objective

- Fundraise to help cover operating expenses or deficit or purchase of equipment
 - Usually NPOs that are organized for social welfare, civic improvement, or pleasure or recreation may do this
 - Need to use volunteers
 - Involve activities involving the sale of donated goods or services or games of chance
 - Need to ensure that the scope of the fundraising is not so significant that it can be considered to be a purpose of the NPO

- In CRA View 2011-0427611I7, after evaluating the information presented to it, CRA determined that the NPOs profits were consistently increasing every year, that its profits were not incidental, and that its profit margins were such that the Organization had a for profit purpose
- Of particular concern was that the NPOs members equity had also increased over the years such that CRA believed that the organization could be accumulating funds in order to earn tax-exempt investment income
- CRA concluded that the NPO had not been operating for a purpose other than profit and did not meet the requirements of paragraph 149(1)(I)

- In CRA View 2011-0408851I7, members of the organization in question were charged a commission on services provided to them, with the net profits being distributed to the members at specified times throughout the year. Because there was a difference in time between the inflow and outflow of money, the money was invested until distribution to the members occurred
- Income from the investments was then used to defray the expenses of the organization and to keep commissions charged to its members as low as possible
- Did the expectation of this income affect its ability to claim NPO status, especially with the organization's desire to minimize the commissions charged to its Members?

- CRA stated that since the organization's reasons for distributing the amounts collected from users to Members was due to non-profit reasons, it was reasonable to expect that the funds would be invested
- The profit from these funds could only be used to help meet operating expenses and not to generate investment income
- CRA indicated that an NPO may maintain a reasonable reserve as long as it is used for a specific capital project or an identifiable operating purpose
- If the investment income was the income of the members and not of the organization (i.e. the organization was an agent of the members with respect to the income), then the investment income would be taxed in the hands of the members and would not affect the tax status of the organization as an NPO

NPO RISK IDENTIFICATION PROJECT

- The NPO Risk Identification Project is in its final months of a 3-year research project on tax compliance in the non-profit sector
- NPOs have been under the microscope of CRA, particularly with respect to the revenue they earn in addition to membership fees
- CRA randomly selected NPOs to review from the 39,000 NPOs that file T2, T3 and/or T1044 returns
 - Over the three years of the project, 1440 NPOs will have been reviewed

- Often, the key question for an NPO that has generated a surplus in a particular year is can it be considered to have been operated exclusively for, and in accordance with, its non-profit purposes
 - This determination is usually made by CRA in respect of a particular taxation year of an NPO on the basis of a review of its yearly activities during the course of an audit

- For example:
 - ABC Professional Association consists of 100 dues paying members and earns significant profits from an annual conference and sale of trade-related publications
 - Assume that 50% of its revenue is from the annual conference and sales (the remainder is from membership dues), and that each of these activities generates a profit of 10% over expenses
 - ABC realizes a surplus each year of 5%
 - In 2011, the organization was audited by CRA in respect of the 2009 taxation year

- Although CRA agreed with ABC that its purposes were non-profit, CRA indicated in an “education letter” that the activities of the conference and the sale of publications were not
- Specifically, the sale of the trade-related publications and conference fees for non-members at higher price was for the purpose of making a profit and aided in keeping these costs low for ABC members
- Although facts above are hypothetical, many existing NPOs, including professional associations and related corporations, have received these “education letters”

- Education letters had caused great concern among NPO sector and prompted many discussions with CRA
- Perrin Beatty, President and CEO of the Canadian Chamber of Commerce wrote a letter on March 13, 2012 to the Minister of National Revenue expressing the concerns of the NPO sector
 - Stated CRA appeared to be unaware of impact of letters on members of NPOs

- Mr. Beatty stated:
 - “Our concern is not with the examination, but with the lack of communications about its purpose and with the Agency’s practice of issuing “education letters” to organizations which have been audited under this process. Although the Agency has often stated that “no conclusions have been reached”, these letters inform the organizations that they are in breach of the Act, and urge them to make adjustments in their activities to comply”
- As of April 23, 2012 CRA was directed by the Minister to stop issuing the education letters and is only providing written views upon request

- CRA now has an informative question and answer section for NPOs to consult <http://www.cra-arc.gc.ca/tx/nnprft/qa-eng.html>
- CRA states that education letters were meant to “raise awareness of the rules governing the benefits available” to NPOs under the ITA and that reassessments are only occurring in the most “egregious cases”
- CRA maintains its position that it is possible for an NPO to generate a profit but
 - the profit must be incidental; and
 - arise from activities that support the organization’s not-for-profit objectives

OTHER EXEMPTIONS

- Because of concerns with respect to reserves and profit-making activities many organizations are considering whether they want to maintain NPO status and/or whether they can claim exemption from tax under other paragraphs of subsection 149(1)
- For example:
 - (c) a municipality in Canada, or a municipal or public body performing a function of government in Canada
 - Mostly Indian bands but may also include quasi-municipal/regulatory organizations

- (e) an agricultural organization, a board of trade or a chamber of commerce, 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
 - Does this include industry associations or professional associations?
- (i) a corporation that was constituted exclusively for the purpose of providing low-cost housing accommodation for the aged
- (j) a corporation that was constituted exclusively for the purpose of carrying on or promoting scientific research and experimental development
- (k) a labour organization or society or a benevolent or fraternal benefit society or order

SOME PRACTICAL ISSUES/COMMENTS

- Questions to ask:
 - Does the organization continue to meet the definition of a non-profit organization under the ITA?
 - Are the organization's objects sufficient to ensure that it is not a charity, e.g., by including in its objects a disqualifying clause such as lobbying for legislative change?

- Does the organization earn a profit from a particular activity? If so, is the earning of the profit incidental or intentional, how much profit is earned from each activity and what is the profit used for?
- Does the organization maintain reserves in excess of a reasonable level acceptable to CRA?
- Be careful about how capital projects are funded, CRA suggests this may only occur through increased member fees
- Does the organization carry out revenue activity within a taxable entity? If so, governance issues will need to be carefully considered
- Is the organization filing all required income tax forms?

CONCLUSION

- Recent CRA views create uncertainty for NPOs and limit their revenue-generating capacity
- While these views are open to challenge on the basis that they contradict existing jurisprudence, NPOs seeking to comply will have to look closely at their revenue-generating activities and take proactive measures to ensure that they are not caught offside the CRA's recent administrative positions
- Still remains to be seen though what the outcome of the Risk Identification Project will be and whether activities such as ABCs will continue to be off-side of CRA requirements

CORPORATE UPDATE

1. ***New Canada Not-for-Profit Corporations Act*** **(“CNCA”)**

- *Canada Corporations Act* (“CCA”) has not been substantively amended since 1917
- On June 23, 2009 *Canada Not-for-Profit Corporations Act* (“CNCA”) received Royal Assent
- CNCA was proclaimed into force on October 17, 2011
- The new rules do not apply automatically to CCA corporations
- Existing CCA corporations will have until October 17, 2014 to continue under the CNCA or face dissolution

2. **New Ontario *Not-for-Profit Corporations Act, 2010* (“ONCA”)**

- The Ontario *Corporations Act* (“OCA”) has not been substantively amended since 1953
- ONCA introduced on May 12, 2010 and received Royal Assent on October 25, 2010
- Expected to be proclaimed in force on July 1, 2013
- Only an outline of the proposed regulations and checklist has been released for public comment

THANK YOU

Karen J. Cooper
kcooper@carters.ca
(613)235-4774

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