

Allowing Charities to “Do More Good” through Carrying on Unrelated Businesses

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ABSTRACT

One way in which charities could increase their positive impact on society is by raising revenue through carrying on a business. Current income-tax legislation in Canada, however, restricts the ability of charities to do so by prohibiting them from carrying on an unrelated business. This article reviews the current law and explores the options for loosening this restriction, while at the same time addressing the potential problems associated with charity-operated businesses. In the end, the author recommends that all charities except private foundations be permitted to operate small businesses, so long as the business activities are disclosed to donors.

RÉSUMÉ

Les œuvres caritatives pourraient augmenter leur impact positif sur la société en faisant accroître leur revenu au moyen d'une activité commerciale. Au Canada, cependant, la loi actuelle de l'impôt sur le revenu restreint la liberté des œuvres caritatives en les interdisant de gérer un commerce sans lien avec leur activité principale. Cet article passe en revue la loi actuelle et explore les options pour libéraliser la loi, tout en recensant les problèmes potentiels associés aux commerces qui seraient gérés par des œuvres caritatives. Au bout du compte, l'auteur recommande que toute œuvre caritative à l'exception de la fondation privée ait la permission de tenir une petite entreprise, en autant que l'œuvre mette ses donateurs au courant de son activité commerciale.

KEYWORDS / MOTS CLÉS : Social enterprise; Taxation of charities / Entreprise sociale; Imposition d'œuvres caritatives

INTRODUCTION

Canada's tax treatment of entities combining for-profit and nonprofit goals has been criticized as falling behind the social enterprise (SE) movement (Canada's National Advisory Board to the Social Impact Investment Taskforce [CNAB], 2014; Hayhoe & Valentine, 2013). In Canada, the taxation issues surrounding SEs in general have been largely unexamined by academics, and the literature coming out of the United States has been divided on the issue of their appropriate tax treatment (Malani & Posner, 2007; Mayer & Ganahl, 2014). This article endeavours to address the narrower question of whether the restrictions on commercial activities carried out by charities should be changed in order to allow charities to more easily carry on a SE and, if so, then how.

The vast majority of Canadians view charities as making important contributions to quality of life (Lasby & Barr, 2013). As governments have provided fewer services in recent decades, charities have increased their role in providing public goods and services (Burrows, 2009). The federal government has encouraged this through increasing tax incentives, such as the first-time donor tax credit and favourable tax treatment for certain donations of capital (Canada, Department of Finance, 2013, 2015). Although many charities already see themselves as operating a social enterprise (Lasby, 2013), their ability to do so is restricted under the Income Tax Act. Charities could contribute even more to society with additional sources of funding, such as through successful business operations.

Although governments have recently encouraged donations to charities through changes in tax legislation, charities are very heavily regulated and have, in recent years, been subject to intense scrutiny. For example, the previous federal government appeared to have stepped up its audits of charities, particularly where it viewed the charities as carrying out a political agenda (Floyd, 2015). An argument to allow charities greater freedom in their operations conflicts with this suspicious view of charities, and it would therefore seem unlikely that charities will be given carte blanche to enter into the economic mainstream. On the other hand, the recognition that the role charities play is important to society through favourable tax changes indicates a willingness to support charities. This article recognizes the complex situation of governments, as both beneficiaries and regulators of charities, and proposes that current restrictions be loosened, but along with safeguards to protect against the negative implications that are associated with charity-run businesses.

The article proceeds by reviewing the current restrictions on the ability of charities to carry on a business, followed by a policy analysis. Drawing on Canadian and U.S. literature and industry-led reports, the article concludes that there are good reasons to clarify and relax these restrictions, based on the ability of charities to make positive contributions to society. At the same time, the literature has identified some concerns with permitting charities to carry on a business. This article identifies core policy objectives underlying these concerns and recommends measures that can help to address them. It also describes and evaluates a number of policy options for implementing these measures. This analysis leads me to conclude that all charities except private foundations be permitted to operate small businesses that are disclosed to donors.

CURRENT IMPEDIMENTS TO CHARITIES OPERATING A BUSINESS

Registered charities are offered two important income tax benefits under Canada's Income Tax Act (ITA, 1985): an exemption from tax (ITA, 1985, s.149(1)(e)), the ability to issue receipts to entitle donors to a tax credit (in the case of individuals; ITA, 1985, s.118.1) or a deduction (in the case of corporations; ITA, 1985, s.110.1(1)), and the ability to receive transfers or donations from other charities (usually charitable foundations). In exchange for these advantages, charities are subject to a large host of regulatory requirements and restrictions.

Two of these restrictions, the exclusively charitable requirement and the prohibition on unrelated business, directly impede commercial activities and, thus, the ability of charities to carry out a social enterprise.

THE EXCLUSIVELY CHARITABLE REQUIREMENT

There are three types of registered charities under the ITA: charitable organizations, public foundations, and private foundations (ITA, 1985, s.248(1) “registered charity”). A charitable organization must devote all of its resources to charitable activities (including related businesses) that it carries on itself (ITA, 1985, s.149.1(6)), while foundations must be operated exclusively for charitable purposes, which includes disbursing funds to other registered charities (ITA, 1985, s.149.1(1) “charitable foundation,” “charitable organization”). Although there is a difference in wording in the requirements, they have generally been conflated to require all types of charities to be operated exclusively for charitable purposes (Canada Revenue Agency, 2003, para. 3; Vancouver Society of Immigrant and Visible Minority Women v. Canada, 1999, paras. 153–154).

Since the term “charitable” is not defined in the ITA, tax administrators and courts have looked to the common law, almost exclusively relying on the four categories set out in the 1891 British Pemsel case: relief of poverty, advancement of education, advancement of religion, and other purposes beneficial to the community. Further, the organization must also be established for public benefit (Vancouver Society of Immigrant and Visible Minority Women v. Canada, 1999, para. 147). This interpretation of the term “charitable” not only restricts charitable missions in general, but also means that many SEs cannot choose to operate as a registered charity, despite offering societal benefits. For example, organizations with a solely environmental mission will only qualify as registered charities if they fall under the fourth and residual category, which has been closely guarded by tax administrators and courts (Vancouver Society of Immigrant and Visible Minority Women v. Canada, 1999, paras. 175–179). While changing the definition of “charitable” may be worthy of consideration, this issue is beyond the scope of this article.

In addition to the restrictive definition of charity, SEs seeking registered charity status must also be wary of the exclusively charitable requirement, as the enterprise may amount to non-charitable activities or a non-charitable purpose. Paragraph 149.1(6)(a) of the ITA makes it clear that a related business is a charitable activity.

THE PROHIBITION ON UNRELATED BUSINESSES

Under the ITA, the Minister can revoke registration of a charitable organization or a public foundation carrying on a business other than a related business (1985, ss.149.1(2),(3)). A “related business” is not exhaustively defined, but the ITA provides that it includes a business unrelated to the charity’s purposes if all persons employed in carrying on the business are volunteers (1985, s.149.1(1) “related business”). The current interpretation of the unrelated business restriction by the courts and the Canada Revenue Agency (CRA) is discussed later in this article. Private foundations, which are foundations that do not meet the arm’s-length requirements of public foundations, cannot carry on any business whatsoever (ITA, 1985, s.149.1(4)).

The government commentary surrounding the introduction of the unrelated business restriction provides important context. Both the 1976 Budget and the preceding discussion paper on the tax treatment of charities noted that the existing law did not (strictly speaking) permit charities to carry on a business because of the exclusively charitable requirement, but that charities were, in fact, carrying on “worthwhile fund-raising activities” and commercial activities such as art gallery gift stores, hospital cafeterias, and sales of used clothing (Canada, Department of Finance, 1975, paras. 13–15; Macdonald, 1976). The discussion paper noted that the proposal

would permit charities to carry on a business related to charitable activities, but that “[t]he provision would make clear that the test would not be the fact that the income earned by the business is used for charitable purposes, but rather that the business is a usual and necessary concomitant of the charitable activity” (Canada, Department of Finance, 1975, para. 15). This strongly suggests that the unrelated business restriction was not intended to be interpreted by looking only to the use of the profits (i.e., a “destinations test”), but that the purpose was to permit charities to continue their worthy endeavours to further their charitable purposes.

Relatively new rules permit the Minister to implement intermediate sanctions for non-compliance, including a penalty of 5 percent of gross profits for carrying on a business other than a related business and 100 percent penalty for repeat offences (ITA, 1985, ss.188.1(1)-(2)). The penalty bears no relation to tax rates, does not permit deductions, increases in subsequent instances, and may eventually lead to loss of registered charity status. This clearly penal provision, described as “severe” and “excessively punitive” (Hayhoe & Owens, 2006, p. 73), can be contrasted with the unrelated business income tax in the United States, with the stated intention of ensuring that businesses operated by charities bear an appropriate tax burden (Mayer & Ganahl, 2014).

CIRCUMSCRIBING THE RESTRICTIONS THROUGH A SUBSIDIARY CORPORATION

One solution to overcoming the barriers identified above is for the charity to use a subsidiary corporation to operate the business. This has, it seems, been approved by the CRA as meeting the exclusively charitable requirement (CRA, 2003, para. 46). Of course, the separate entity would be subject to tax. However, as corporations can deduct up to 75 percent of income donated to registered charities (ITA, 1985, s.110.1), taxes may be fairly low if profits are paid to the parent charity. Further, the corporation may be entitled to reduced tax rates where the small business deduction is available.

The corporate structure has the added advantage of accessing equity capital from investors. Further, using a separate corporate entity would protect the charity’s other assets (Carter & Man, 2009). However, by using a subsidiary corporation, charities face additional incorporation and administrative costs, which simply may not be feasible for small-scale endeavours and trials (CNAB, 2014). For example, charities are advised that operations should be kept separate, including separate space, and separate boards should govern the entities (Markey, Corriveau, Cody, & Bonfield, 2011). Moreover, while using a subsidiary is an option for charitable organizations, charitable foundations must be cautious of using a subsidiary since they are not permitted to have control over a for-profit entity, though work-arounds are possible to avoid this rule (CNAB, 2014; Travers, Thorimbert, Magdalinski, & Anderson, 2013).

INTERPRETING THE UNRELATED BUSINESS RESTRICTION

This part of the article reviews the interpretation of the unrelated business restriction by the courts and the CRA.

The demise of the destinations test

There is an underwhelming body of case law on the meaning of “related business.” Two pivotal cases are reviewed below to explain the endorsement and subsequent rejection of a “destinations test,” namely *Alberta Institute on Mental Retardation v. Canada* (1987) and *Earth Fund v Canada* (2002).

Alberta Institute on Mental Retardation v. Canada

In *Alberta Institute on Mental Retardation v. Canada*, the appellant, AIMR, was formed in order to raise funds for a variety of charities benefiting people with mental disabilities. AIMR was compensated by Value Village Stores

Ltd. for collecting goods to be sold in Value Village stores. The issue was whether AIMR was a public foundation charity under the ITA. The Minister's view was that it was not because it was not operated exclusively for charitable purposes and it carried on an unrelated business.

With respect to the first issue, Justice Heald, for the majority, decided that AIMR was carrying out its objects, which included the ability to raise funds to carry out the objects of the company.

The second issue considered by the majority was whether AIMR was carrying on a business that was not a related business. The majority adopted the four factors proposed by Drache (1980):

- The degree of relationship of the activity to the charity;
- Profit motive;
- The extent to which the business operation competes with other businessmen; and
- The length of time the operation has been carried on by the charity.

Here, the majority applied the test as follows, finding only the first two factors relevant here:

In my view, the factual situation at bar satisfies the first test ... because the commercial operation at bar is exclusively related to charitable purposes since all monies collected are so allocated. Accordingly, the commercial activity has a very close connection with the charity. Likewise, the second test is met since there is no profit motive in the appellant's operation. All monies received are remitted to the Association... (AIMR, 1987, pp. 298–299)

The majority concluded that the activity here was “of the kind clearly envisaged by the charities amendments as being included in the expression ‘related business of that charity’ ” (AIMR, 1987, p. 299). The majority's decision in the AIMR case was subsequently used to support a destination test, under which the use of the funds for charitable purposes was sufficient to constitute a related business.

Justice Pratte, in dissent, opined that AIMR was carrying on an unrelated business, arguing that there must be a relationship between the charitable objects and the business activities and not just the use of profits for a charitable purpose (AIMR, 1987, p. 289). Otherwise, it would be unnecessary to have the unrelated business restriction, as the only “off side” commercial ventures would infringe on the exclusively charitable requirement anyway (AIMR, 1987, p. 289).

Earth Fund v Canada

In *Earth Fund v Canada*, the appellant raised funds for environmental groups through lotteries. The appellant entered into contracts with other corporations to operate and market the lotteries, as well as to hold the intellectual property associated with the lotteries. The Federal Court of Appeal considered whether a charitable foundation could carry on a lottery business. The Court did not agree with the appellant that the AIMR case was authority for a destination test. Rather, the facts in that case were such that the foundation was “simply soliciting donations of goods which it converted to money” and that although this “was somewhat different from the traditional fundraising activities of a foundation,” the Court opined that “the difference is only a matter of degree” (*Earth Fund*, 2002, para. 30). Here, however, the lottery was a commercial enterprise, with nothing distinguishing it from a commercial enterprise other than its promise to give profits to qualified donees. In the Court's view, “[s]uch a commitment, by itself, does not derogate from the commercial nature of the activity that generates the profit” (*Earth Fund*, 2002, para. 31). Therefore, the lottery was an unrelated business.

Canada Revenue Agency's administrative position

Shortly after the Earth Fund decision, the CRA set out its administrative position in CPS-019 "What Is a Related Business?" (2003). The CRA breaks the issue down into three sub-questions: 1) What is a "business"? 2) What is "carrying on" a business? and 3) What is a "related business"? The CRA's analysis fills in the gaps left by the court decisions by undergoing a fairly comprehensive evaluation of all three questions.

In determining the existence of a business, the CRA cites *Stewart v R* (2002) to identify four factors: "The intended course of action ... the potential to show a profit ... the existence of profits in past years and ... the expertise and experience of the person or organization that undertakes the activity" (CRA, 2003, para. 4). Therefore, in the CRA's opinion, soliciting and selling donations and charging fees in certain situations would not amount to a business (2003, paras. 5–8). The second question, whether the entity is "carrying on" a business, is interpreted by the CRA as requiring "a continuous or regular operation" (2003, para. 9). Holding fundraising events, providing they are infrequent, would not meet this definition, nor would earning income from passive investments (CRA, 2003, paras. 12–14). Further, training "businesses" and social "businesses" for individuals with disabilities are often not considered businesses at all by the CRA (CRA, 2012).

Although it does not explicitly do so, the CRA tacitly affirms the Federal Court of Appeal's rejection of the destinations test. If the application of profits toward charitable purposes is an insufficient link, then how is a "related business" defined? In the CRA's opinion, a related business is both linked to the charity's purpose and subordinate to that purpose. Examples of valid links include "a usual and necessary concomitant of charitable programs" (including hospital parking lots and cafeterias), "an off-shoot of a charitable program" (such as selling church service recordings), "a use of excess capacity" (such as empty classrooms), and "sale of items that promote the charity or its objects" (CRA, 2003, paras. 21–30). In order to meet the subordinate to charitable purpose requirement, the CRA indicates one should look to the relative attention and resources the business demands, the level of integration within the charity's operations, the extent to which charitable goals continue to dominate decision-making, and the continued absence of private benefit (CRA, 2003, paras. 31–43).

The result: Opportunities for charities to operate a business are limited

The legislation limits the businesses carried on by registered charities to related businesses. While there were earlier indications that using profits from a business would be sufficient to consider the business to be related, recent cases have rejected this destinations test, favouring an interpretation that further restricted the ability of charities to carry on a business.

Unfortunately, the case law has not progressed to replace the destinations test with a framework for determining when a business will be considered to be unrelated to the charity. This leaves charities to look to the CRA's interpretation guidelines, which do appear to permit some level of commercial activity. However, the interpretation is lacking clarity in a number of respects, leaving uncertainty (Godel, 2007). First, since there are no principles to inform the application of the CRA's list of "on-side" ventures, it is difficult for charities to determine whether their endeavour qualifies as related. Second, the CRA interpretations are not law and are vague enough so as to not bind the CRA, even in the non-legal sense. Third, given the aforementioned recent scrutiny of charities by the CRA, it is likely that many charities will be overly cautious and not enter into commercial arrangements even where it is quite possible they would properly be considered a related business.

Thus, the legislation, when combined with the rejection of the destinations test by the courts, severely restricts the ability of charities to carry on a business. Assuming the ability of charities to carry on a business should be

expanded, the only reasonable way in which this can be changed is through legislative reform, as is discussed in the latter part of this article.

Relaxing restrictions on carrying on an unrelated business

The law certainly could be clarified through legislative amendments or court decisions addressing the uncertainties outlined above. Most importantly, in order to achieve greater certainty, the law would need to describe the necessary link between the business and the charitable operations in order to be considered a “related” business. However, the focus of this article is not how the existing law should be codified and clarified; it is on the policy question of whether and how the law could be modified to expand the ability of charities to carry on an unrelated business.

The idea that charities should have an expanded ability to carry on a business is supported by public opinion, as survey results show that 79 percent of Canadians believe that charities should be able to engage in any type of business activity (Lasby & Barr, 2013). This viewpoint also has some support in academic writing. Kevin E. Davis (2001) has argued that Canadian charities be permitted to carry on businesses to a greater extent than under existing legislation. South of the border, Dana Brakman Reiser (2011) has persuasively argued that the unrelated business restriction should be removed under United States income tax law. Further (and perhaps not surprisingly), there is support within the charitable sector for reform. For example, reports in 2010 and 2014 with strong industry representation recommended easing the restriction in Canada, with the earlier report recommending the use of the destination test (Canadian Task Force on Social Finance, 2010) and the more recent report recommending allowing charities to operate unrelated businesses (CNAB, 2014). A 2013 Finance Committee report noted that organizations had advocated for further discussions relating to charities carrying on for-profit enterprises and reviving the destinations of profits test (Standing Committee on Finance, 2013).

The analysis in this part first proceeds by outlining the reason for permitting charities to undertake commercial activities in order to justify loosening the restrictions. The article then outlines the main concerns with charities carrying on a business, and then describes four mechanisms that could alleviate these concerns while still permitting charities to carry out unrelated businesses.

The justification for allowing charities to undertake commercial activities

The most frequently accepted justification for the charitable tax exemption is the widely held belief that charities benefit society (Parachin, 2012; Royal Commission on Taxation, 1966). In fact, a recent survey has shown that the majority of Canadians believe that charities do a better job than government in meeting the needs of Canadians (Lasby & Barr, 2013). As governments retreat from providing public services, charities have played an increasingly important role in filling the gap (Burrows, 2009).

One way in which charities can expand the societal benefits they provide is through commercial ventures, which may either directly achieve their mission through the commercial operations themselves or provide more funds to achieve their mission. Other researchers have noted that in times of declining public funding, greater demand for services, and increased competition for donor funding, alternative sources of funding can be valuable to charities (CNAB, 2014; Neilson, Brouard, & Armenakyan, 2003; Tindale & MacLachlan, 2001). Since the government has already decided through granting charitable status that the charity’s mission provides a benefit to society, it could be argued that regulation should not unnecessarily impede the extent to which that mission can be achieved through commercial activities. Stated in another way, finding innovative ways to achieve charitable purposes should be encouraged rather than needlessly hampered (Brakman Reiser, 2011; CNAB,

2014; Davis, 2001). As Davis (2001) states: “[T]he principal object of the law of charities, including the rules governing charities’ commercial activities, should be to facilitate the doing of charity” (p. 497).

The concerns with charities carrying on a business

The literature has identified concerns about charities carrying on commercial activities, including 1) lack of focus on mission due to a shift in profit focus (Brakman Reiser, 2011; CNAB, 2014; Davis, 2001); 2) unfair competitive advantage as compared to taxable entities (CNAB, 2014; Davis, 2001); 3) risk of business failure leading to financial loss (CNAB, 2014; Davis, 2001), and 4) tax base erosion due to the tax-exempt status of charities (Brakman Reiser, 2011). The underpinnings of each of these concerns and the degree of risk associated with them are discussed below, followed by a list of measures that could help to alleviate these concerns.

Losing focus on mission

Though another key restriction on charities, the prohibition on distribution of surplus, has been viewed as the primary safeguard against straying from mission, prohibitions on commercial and political activity have also been viewed as important protective measures (Brakman Reiser, 2011). Entering into the commercial realm, it is argued, may cause decision-makers to lose sight of the charity’s mission and instead focus on profits (Murray, 2008). Resource dependence theory predicts that missions will drift and change, along with funding sources (Fritsch, Rossi, & Hebb, 2014). Altruism and public benefit are at the very core of the definition of charity (Vancouver Society of Immigrant and Visible Minority Women v. Canada, 1999), and the mission-driven definition of charity is tied closely to the altruistic core. Further, opponents argue that allowing charities to carry on businesses might attract self-motivated people disguising themselves as charitable to meet their secret profit-making goals (Brakman Reiser, 2011). Although the distribution prohibition precludes personal profits, the opportunity for personal profits exists through secretive means such as elevated salaries and contract payments (Brakman Reiser, 2011).

At the core of the concerns surrounding mission drift are two government objectives. First, governments are invested in ensuring that charities are “doing good” to warrant their special tax treatment. Second, governments have seen fit to protect donors and ensure that their donations are being used in pursuit of the charity’s mission.

Davis (2001) argues that preventing commercial activities is an overly restrictive reaction to mission drift, as some types of mission drift (e.g., a shift to a new charitable purpose) are generally benign and other regulatory options are more appropriate. Imagine Canada (2013) points out that earned income can actually create opportunities for a greater focus on mission. Also, although focus might be divided between charitable activities and business activities, successful business endeavours can provide funding to help charities better achieve their mission. So, if safeguards are in place to help charities stay committed to their mission, they may actually be more successful in achieving their mission-related goals. Indeed, commercial enterprises will not necessarily lead to erosion of charitable mission (Tindale & MacLachlan, 2001).

Risk of failure

Perhaps a less commonly identified concern is that some commercial ventures will fail (Murray, 2008). The existing restriction on carrying on a business may provide some assurance to donors that their money will not be “wasted” on a failed business. Also, to the extent that a business loses money, resources of the charity are eroded, and the societal benefits produced by the charity will be reduced. Thus, two policy goals are at the root of the concerns about risk of failure: protecting donors and producing societal benefits.

Although survey results have shown that Canadians believe charities should be given freedom to engage in business activity, 70 percent worried about the charity losing money on a bad business venture (Lasby & Barr, 2013). Imagine Canada (2013) points out that 30 to 60 percent of businesses fail. There are conflicting viewpoints on the ability of charities, in particular, to carry out successful business ventures. Tindale and MacLachlan (2001) state that charities may not have the expertise needed to focus on making a profit. On the other hand, Davis (2001) argues that there is a lack of evidence showing that charities are inefficient, and points out that charities may be particularly well positioned to operate successfully in certain cases, such as where economies of scope exist.

Tax base erosion

If businesses are carried on through exempt charities rather than taxable entities, this could lead to tax base erosion (Murray, 2008). Charities currently may carry on a business through a taxable subsidiary corporation. If, instead, charities carry on the businesses directly and do not pay tax, governments will lose out on revenue they would have earned through taxes imposed on the subsidiary corporation. However, this problem may not be as great as it initially seems, as the subsidiary would be able to deduct a charitable donation of up to 75 percent of its profits (ITA, 1985, s.110.1(1)). Still, as the profits that are not donated and any donated profits in excess of 75 percent would be taxed, tax base erosion would be a valid concern if charities were permitted to carry on tax-exempt unrelated businesses.

Two government objectives underlie the concern of tax base erosion: government revenue generation and fairness. Within the tax system, horizontal equity demands that taxpayers in a similar position (i.e., with the same income) pay the same amount of tax; however, deviations from this principle may be justified as tax expenditures where other policy goals are pursued (Hogg, Magee, & Li, 2010). So, while it could be argued that a tax exemption for unrelated business earnings is justified because of the societal contributions of charities, the argument is less strong than in the case of related businesses, where presumably there are additional public benefits achieved directly through the business operations.

Unfair competition

It has been argued that to the extent that charities are permitted to carry on a business and escape taxation on such earnings, charities would have unfair advantages over for-profit organizations offering similar products or services (Binder, 2013; Davis, 2001; Mayer & Ganahl, 2014; Murray, 2008). On the other hand, it has been argued that unfair competition is not as great a concern as it may seem (Rose-Ackerman, 1982). For example, there are disadvantages of operating as a charity, including inefficiencies (Rose-Ackerman, 1982) and an inability to raise equity capital.

Unfair competition concerns are derived from the policy goals of protecting the free market (the heart of our capitalist economy) and fairness, which demands that market players not be given a competitive advantage without good justification.

Addressing the concerns

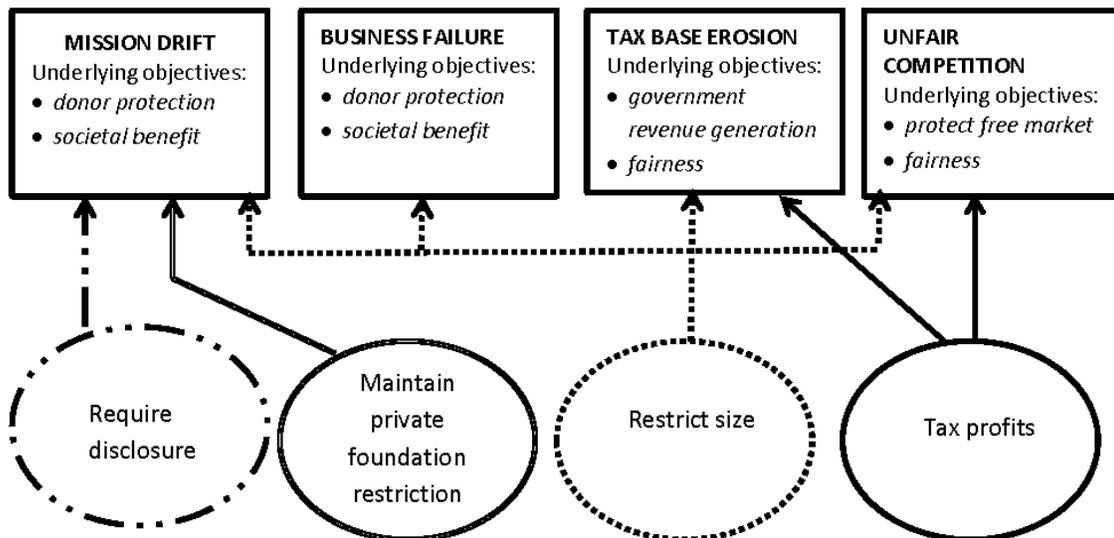
Murray (2008) points out that while Canada and Australia have an “all or nothing” approach, several other countries permit charities to carry on “undesirable” (usually unrelated) businesses, with losing only the tax exemption, but not charitable status (p. 201). Murray (2008) questions whether the line should be drawn by demanding a connection between the business activities and charitable purpose, as the concerns relating to operating a business exist in most cases regardless of this connection. However, it is argued here that the reason for this “line” can be justified not because related businesses are less likely to inflict such concerns, but

that such concerns are counterbalanced against the good that comes directly from operating such businesses. For example, the job training relating to a business employing individuals with disabilities produces additional societal benefit that justifies possible negative effects, such as unfair competition.

Recall that the alternative to carrying on an unrelated business directly is to operate the businesses through a subsidiary, a practice apparently endorsed by the CRA. Investing in a subsidiary that carries out the unrelated business eliminates the competition and tax base erosion concerns identified above. Mission concerns may be alleviated if measures are implemented to give greater assurance of separate management and control of operations the subsidiary (such as a separate board of directors, physical spaces, and management), and such measures may be wise whether or not other changes are made to the unrelated business restriction. The business risks involved where a subsidiary is used will be the same as in the case of other investments and will need to be assessed by the charity accordingly. Ideally the legislation would be changed to specifically allow for charities to carry out an unrelated business through a subsidiary in order to eliminate the need to rely on a CRA administrative position.

While requiring a connection between the business activities and charitable purpose does have some merit in that it helps to reduce the potential negative effects associated with charities carrying on a business, it is possible that the concerns could be addressed in other ways. If charities are permitted to carry on an unrelated business, the concerns could be addressed in four ways: 1) restricting the size of the unrelated business, 2) requiring disclosure of unrelated businesses carried on by charities, 3) maintaining the prohibition on businesses for private foundations, and 4) taxing unrelated business profits. The use of each of these measures is described below, and Figure 1 shows how each of these relates to the four concerns identified in the previous section.

Figure 1: Concerns re charities carrying on a business and potential solutions



Perhaps not surprisingly, working through the details leads to the potential for considerable complexity that always needs to be kept in mind when making policy decisions. In addition to adding complexity, adding these measures has the potential to decrease the benefits of permitting charities to carry on an unrelated business, as compared to an unrestricted ability to carry on such a business. The degree to which complexity and reduced ability to carry out their mission (and therefore bring a benefit to society) is set out in Table 1, although, as will be discussed below, the extent of the cost will often depend on how the measure is implemented.

Table 1: Four policy options and their costs and benefits as compared to unrestricted elimination of unrelated business prohibition

	Disallow unrelated businesses	Require disclosure	Ban private foundations	Restrict size	Tax profits
Benefit(s)	Reduces extent/risk of: mission drift, business failure, tax base erosion, and unfair competition	Prevents mission drift	Prevents mission drift	Reduces extent/risk of: mission drift, business failure, tax base erosion, and unfair competition	Eliminates unfair competition and tax base erosion
Cost(s)	Adds complexity (moderate); reduces social benefit	Adds complexity (low to moderate); reduces societal benefit (low)	Adds complexity (low); reduces societal benefit (low)	Adds complexity (moderate to high); reduces societal benefit (moderate)	Adds complexity (moderate to high); reduces societal benefit (moderate)
Policy options					
Status quo	✓		✓		
Option 1		✓	✓		
Option 2		✓	✓		✓
Option 3		✓	✓	✓	
Option 4		✓	✓	✓	✓

Require disclosure

A 2014 National Advisory Board report recommended that charities operating businesses report on their business activities and that the CRA make such reports public on its website, in order to support transparency and accountability (CNAB, 2014). This could help to ensure charities stay committed to their mission and inform donors about business risks, and also could assist the CRA with compliance efforts. To meet these goals, the reporting should convey both financial information as well as a detailed description of the business activities. A balance would need to be struck between providing sufficient information and imposing excessive compliance costs on the charities.

The prescription for greater reporting is consistent with the views of Canadians that it is important that charities provide information, and should do a better job at providing it (Lasby & Barr, 2013). A discussion paper by a group of academics, government representatives, practitioners, and professionals discussing improvements to the T3010 form to assist with research reported that the majority believed that more reporting was needed on social enterprises operated by charities (Brouard, 2014). In other words, providing additional information about

businesses could help to inform donors if the restrictions are loosened, but also would serve the interests of donors and researchers regardless of whether the law is changed to expand the ability of charities to carry on businesses. Additionally, the complexity costs of implementing this measure are relatively low and it is likely to have little impact on the ability of charities to carry out their mission.

Maintain the private foundation business prohibition

Dana Brakman Reiser (2011) has argued that restrictions on commercial and political activities “go far beyond discouraging self-regarding behavior and chill charities’ pursuit of legitimate mission-related programs” (p. 3). She persuasively argues that the focus should instead be on ensuring that other-regarding (as opposed to self-regarding) behaviour is present, and that one way in which this can be achieved is through group control over charities (Brakman Reiser, 2011). In the Canadian context, this suggests that private foundations should not be granted the same freedom to carry on a business. Due to the increased risks associated with closely managed charities, it is not recommended here that private foundations be permitted to carry on a business. In fact, it could even be argued that the CRA’s existing interpretation of carrying on an unrelated business may go too far to allow private foundation charities to be involved in commercial activities, and perhaps further restrictions could be considered.

Restrict size

Restricting the size of the unrelated business could help to address all four of the identified concerns relating to charities carrying on an unrelated business. Charities are more likely to be swept up in profit-making goals (therefore diverting focus on mission) in the case of ventures that are large by comparison to the overall size of the charity. Also, the risk of loss becomes greater for ventures that are large relative to the size of the charity since relatively small losses could likely be more easily absorbed or otherwise protected against. Further, tax base erosion would be of lesser concern if profits were capped, and small businesses would be less likely to pose a significant competitive threat to other businesses.

Since charities can currently carry out unrelated businesses through a subsidiary, it is most important to consider removing barriers to carrying out smaller businesses where incorporation costs are prohibitive. Therefore, it would seem to make sense to cap the size of profits of unrelated businesses at an amount where the profits make it economically feasible to incorporate a subsidiary. In order to cut down on the risk of unreasonable allocation of the charity’s running expenses to the business, there could also be a higher gross income cap as a backstop. If it were anticipated that the small business would soon become too profitable to fit within the size cap, assets should be transferable to a subsidiary on a tax-deferred basis under s.85(1).

Although allowing for small unrelated businesses would add complexity as compared to an unrestricted ability to carry on an unrelated business, the charity could decide whether the endeavour would be promising enough to outweigh the associated costs of complying with the size cap. There would be additional audit and implementation costs to the government that would need to be considered. While restricting size would dampen the positive aspects of permitting charities to carry on an unrelated business, it is feasible for larger unrelated businesses to be operated through a subsidiary corporation.

Tax profits

Interestingly, most Canadians do not think that charities should have to pay tax on their business profits so long as the money is used to support their cause (Lasby & Barr, 2013). A tax policy assessment, however, does not have the same result. The Carter Commission’s seminal report on tax policy recommended that business income earned by charities should be taxed (Royal Commission on Taxation, 1966). Brakman Reiser (2011)

and the 2014 National Advisory Board report also recommend that some or all of the business profits earned by a charity should be taxed. There is a strong horizontal equity argument for taxing profits, since for-profit businesses are taxed. A case can be made for exempting businesses whose activities substantially contribute to charitable goals, since the potential to produce societal benefits goes further to outweigh competition and equity concerns as compared to situations where the businesses have a lesser connection to mission. It is therefore proposed here that only the former category of businesses (i.e., related businesses) be exempt from tax. That is, tax should be imposed on businesses that are connected only by making financial contributions to further charitable mission.

Another important question is the relevant rate to be applied to business earnings. Personal rates could be seen as appropriate, as corporate rates represent only one aspect of the full tax on corporate business earnings (the other being the taxation rate applied to the shareholder, after dividend gross ups and dividend tax credits). However, so long as the alternative of using a subsidiary continues to be available, corporate rates may be most logical. The reduced rate for Canadian-controlled private corporations (CCPCs) would likely be available to most subsidiaries, and the CCPC rate should therefore be made available to taxable businesses operated by charities (CNAB, 2014) so long as CCPC-equivalent criteria are met.

Horizontal equity demands that taxable businesses operating within a charity be permitted to take regular business deductions. A more difficult issue is whether a deduction should be permitted to the extent that the profits are dedicated to the charity's mission, up to the maximum of 75 percent of income, as is permitted for corporations. This would put businesses operated directly by charities in the same position as subsidiaries operated by charities and other corporations that chose to make donations to charities, and thus has intuitive appeal. To avoid charities simply substituting other funds to further invest in the business, the rule would need to look to the size of reinvestment in the business relative to the size of business profits, regardless of the source of the investment. That is, if the charity injected capital exceeding 25 percent of the business's profits, the full 75 percent deduction would no longer be available. This would ensure that, like businesses operated through separate corporate entities, the deduction is available where the business forgoes reinvesting in business growth in order to further the mission of the charity.

There would certainly be revenue gains to the government if taxes were imposed on unrelated businesses, although if deductions are permitted (up to a maximum of 75 percent of profits) for funds dedicated to the charity's mission, the revenue gains may not be large. There would also be a significant complexity cost to both charities and governments if taxes were imposed. Additionally, if business profits were taxed, the reduction in profits due to taxes payable and administrative costs would reduce the "good" produced by the business through its contribution to charitable activities.

Evaluating the policy options

The four options set out in Table 1 would allow charities the ability to carry out an unrelated business, putting different measures in place to address the previously identified concerns. To assist with evaluating the different options, the benefits and costs of each measure (as compared to unreservedly removing the unrelated business impediment) are also set out in Table 1.

Disclosure and private foundations

All of the options would require disclosure of the business to donors and would continue to ban private foundations from carrying on an unrelated business. Both of these measures carry relatively low complexity

costs and would have a minimal impact on charities being able to produce benefits to society, and their implementation could help to offset some of the concerns about mission drift.

Option 1

The first option would allow unrelated businesses of unrestricted size without taxing profits, but this would seem unwise from both a policy and political perspective. The concerns about unfair competition and, in particular, tax base erosion cannot be ignored, and therefore must be addressed at least through restricting unrelated business size, taxing unrelated business profits, or both. Although it could be argued that these concerns are not as significant as they might at first appear, they are still valid concerns and may resonate with the public. Therefore, demonstrating that these concerns have been ameliorated, as is done in the other options, may be a political necessity.

Options 2, 3, and 4

Options 2, 3, and 4 would allow charities other than private foundations to carry on a disclosed unrelated business; however, this would either restrict business size or tax business profits, or both. Taxing profits would do the most to eliminate unfair competition and to prevent erosion of the tax base, but restricting size has the added benefit of reducing the risks associated with mission drift and business failure. As option 1 has already been ruled out, the appropriate comparison is between the status quo and options 2, 3, and 4.

As already discussed, the status quo restricts the societal benefit that can be created by charities as compared to a situation where charities could carry on unrelated businesses and apply the business profits to achieve their charitable mission. Although charities can work around this problem by carrying on the business through a subsidiary, this can add costs and complexity that would make small businesses unfeasible. Another area of complexity that exists in the current system involves distinguishing between related and unrelated businesses. However, this complexity would remain in options 2, 3, and 4, as they all require identifying an unrelated business in order to restrict its size or tax its profits.

It would seem, then, that the most objectionable aspect of the status quo is that it prevents charities from pursuing small business endeavours (which could, in time, prove to be quite profitable). As explained in the previous section, it makes sense, then, to cap the size of unrelated businesses at an amount where the profits of the business make it feasible to operate through a subsidiary. In this context of a fairly low size cap, not taxing profits becomes an attractive policy option because it avoids the complexity associated with imposing taxes while minimizing tax base erosion. Therefore, legislative changes in line with option 3 are recommended here.

CONCLUSION

The growth in the popularity of social enterprises has given rise to an interest in facilitating the combination of commercial and charitable goals. At the same time, the ability of charities to engage in commercial activities has been severely hampered by income tax rules, including the unrelated business restriction. It is argued here that if charities “do good,” a premise upon which both the tax system and this article rests, then they should be permitted to “do more good” through carrying on commercial activities. Operating businesses allows charities to access funds to carry on their mission without promising investors a profit and thus engaging in private benefit. So long as commitment to their charitable purposes is maintained, charities should be encouraged to innovate to expand their ability to produce societal benefits. However, it is acknowledged that there are risks involved with allowing charities to enter further into the commercial sphere, which brings into question the appropriate balance between the potential for increased societal benefits versus the potential for harm created by losing

focus on mission, putting for-profit companies at a competitive disadvantage, exposing charitable assets to risk, and eroding the tax base.

Currently, the CRA appears to endorse charities carrying on unrelated businesses through a taxable subsidiary. This solution has appeal, as it requires a separation of the business from the charity and addresses concerns about tax base erosion or competitive advantage. It would be preferable if the use of subsidiaries to carry on an unrelated business were specifically allowed under the ITA, to eliminate any uncertainty as to the appropriateness of their use. However, even if this were done, there would be costs to using a subsidiary that might make it difficult for charities to carry out smaller unrelated businesses, and therefore the unrelated business restriction still would pose a barrier to charities engaging in innovation.

It has been argued in this article that charities should be allowed to carry out an unrelated business, but with some important restrictions. Charities should be required to report businesses to donors, the unrelated business restriction should be maintained for private foundations, and the size of unrelated businesses should be restricted such that only those with fairly low profits would be permitted. Taxing profits on unrelated businesses could be considered as a further restriction, but in light of the complexity this taxation creates it is likely not justified if profits are capped at a low amount. As with most tax policy decisions, the decision about expanding the ability of charities to carry on commercial activities involves a careful weighing of benefits and risks, and the set out here was crafted with due consideration of the competing government policy goals.

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