



## Empowering non-profits to unleash maximum impact: The destination of profits test in Canada

There are approximately 80,000 non-profits in Canada. A nearly equal number of organizations enjoy charitable status.

For the purposes of this paper, the focus is on non-profit organizations (NPO's). These are not to be confused with charities, which are defined in a separate section of the Income Tax Act, and are subject to different CRA guidance when operating social enterprises<sup>1</sup>.

An entity can be either a charity or a non-profit: not both. Charities and non-profits represent distinct categories within the Act; and currently feature vastly different boundaries for social enterprise operation, despite the community sector's common misunderstanding on both of these points.

Unlike charities, NPO's are not 'qualified donees' under the Income Tax Act definition. This means that they are not permitted to receive grants and donations from registered charities and foundations. Therefore, their access to grants is notably limited, as compared to their charity cousins.

Likewise, NPO's are not allowed to issue tax deductible donation receipts. As the vast majority of donors expect a tax break for their generosity, non-profits are also at a dramatic disadvantage when it comes to soliciting donations from individuals<sup>2</sup>.

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<sup>1</sup> See [www.cra-arc.gc.ca/chrts-gvng/chrts/plcy/cps/cps-019-eng.html](http://www.cra-arc.gc.ca/chrts-gvng/chrts/plcy/cps/cps-019-eng.html)

<sup>2</sup> Corporate donors do not require a tax receipt in order to claim promotion-related donations as expenses, so to some extent, some donation revenues from businesses remain an opportunity to non-profits. Unfortunately, many businesses do not understand the nuances of the application of the expense, and nonetheless request a 'tax receipt'. Many non-profits fail to recognize the distinction themselves, so are unable to explain that only a simple receipt is required (i.e. to establish a paper trail), if in fact a promotional benefit is received by the business, so in the process, these groups miss out on some corporate donation opportunities.

Some may ask why non-profits don't 'become' charities, if they face these revenue-sourcing limitations. Canadian organizations that fit within the four heads of charity<sup>3</sup> are actually required to apply for charitable status. Those that do not fit the categories cannot become charities.

The University of Toronto's Mowat Centre for Public Policy and Governance presents the reality for financial sustainability of community-based organizations simply:

'Charities and non-profits rely on three core sources of revenue: government funding, philanthropy, and earned income. Of these, only earned income offers any prospect for long-term growth.'<sup>4</sup>

Given the restrictions placed on NPO's in relation to donations and grants, the second option (i.e. philanthropy) is extremely limited. This leaves government support and social enterprise.

We acknowledge the stresses that are placed on resources of all levels of government, in the face of demographic shifts, enduring poverty and other social challenges, and population growth. Greater expectations are being placed on the community sector to craft social and environmental interventions.

In the face of shrinking government resources and increasingly intractable community issues, non-profits are turning to social enterprise (i.e. the sale of goods and/or services) as a more attractive way to build organizational resilience, while impacting their communities.

Up to a few years ago, the NPO legal structure was generally thought to be a relatively safe container for social enterprise. Beginning in late 2009, the Canada Revenue Agency (CRA) began to issue alarming and consistent guidance suggesting that non-profits are, for the most part, only allowed to generate profit unintentionally<sup>5</sup>, and that regardless of whether the profits are returned back to the organization, those generating intentional profits would be stripped of the income tax exemption of the entire organization, retroactively.

At first, many believed that they could fly under the radar, thinking that CRA was issuing guidance without intent to police their position. But CRA developed a budget for a systematic review of over 1,400 non-profits across Canada<sup>6</sup>. Education letters were issued to those found to be offside. This practice ceased after effective messaging from the Canadian Chamber of Commerce and others.

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<sup>3</sup> These are the relief of poverty; the advancement of education; the advancement of religion; and certain other purposes that benefit the community in a way the courts have said is charitable. Although the fourth category is broad – suggesting that most non-profits could apply under this charitable head, this category is special in that the applicant must find a precedent in case law (i.e. the courts) that recognizes the specific purpose as charitable.

<sup>4</sup> From Strengthening the Third Pillar of the Canadian Union: an intergovernmental agenda for Canada's charities and non-profits by Elizabeth Mulholland, Matthew Mendelsohn, and Negin Shamshiri. March 2011. Page 5.

<sup>5</sup> It appears that profits intended to be invested in physical community assets are permitted. Profits generated to support overhead, administrative infrastructure, or any community benefit not tied to a physical asset are not permitted (unless the profits are 'incidental': CRA provides no sense of how to measure this) without risking the loss of the non-profit's tax exemption.

<sup>6</sup> See [www.cra-arc.gc.ca/tx/nnprft/nprp-eng.html](http://www.cra-arc.gc.ca/tx/nnprft/nprp-eng.html)

CRA's Non-Profit Organization Risk Identification Project Report (released February 2014<sup>7</sup>) states, '... many in the non-profit sector believe that NPO's must produce a profit for their programs to thrive and for their capital assets to be maintained [writer's note: CRA cites this as a 'belief', whereas many in the sector would assert this as fact]. In particular, there is a common view that, as long as profits are used to further the organization's purpose, the source of funding shouldn't matter. However, it is CRA's position that a NPO can earn profits, but the profits should be incidental and arise from activities that are undertaken to meet the organization's non-profit objectives [writer's note: 'unrelated businesses' would therefore not be permitted, whereas charities are allowed to operate these, hived off into a taxable corporation]'

The report then goes on to state that many of the NPO's that were scrutinized would fall into a higher risk category, with most of those subject to loss of their tax exemption, should CRA's stance be applied to the NPO's in question.

The key sticking point of CRA's position lies in the section of the federal Income Tax Act that confers upon non-profits their income tax exemption. Section 149.1(l) is worth quoting:

'... 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...'

The underlining is ours. This is the pivot point of the argument. While the sector argues that the mere existence of profit is not proof that the organization was formed for the purpose of profit, the CRA position seems to be that the very existence of intentional profit is proof that the purpose of the organization is to make profit. Therefore, the non-profit can be stripped of its tax exemption.

When the first CRA rulings were released, we communicated our sense with CRA that if we were understanding the rulings correctly, then approximately 75% of existing non-profits (or 60,000 of the 80,000 organizations across Canada) were currently offside.

CRA replied that they concurred with our estimate.

In recent years, experts have weighed in with alarm. Below are a few examples:

'if NPOs are considered to be carrying on a business, they will lose their non-taxable status and essentially become taxable on all of their operations.'  
BDO Dunwoody, Chartered Accountants

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<sup>7</sup> See [www.cra-arc.gc.ca/tx/nnprft/nprft-prjct-rprt-eng.html](http://www.cra-arc.gc.ca/tx/nnprft/nprft-prjct-rprt-eng.html)

'... [the] recent wave of audits of large and small non-profit entities has created panic and fear among tax practitioners and their clients [and has] left the industry confused, worried and in chaos, to say the least.'

Esmail Bharwani, lawyer

'...run, don't walk, to your lawyer and accountant. The tax problems may be immense.'

Arthur Drache, lawyer

'the almost 1,500 audits of not-for-profit organizations are creating widespread anxiety within the sector, which relies extensively on volunteer Boards and provides important services to Canadians.'

The Canadian Chamber of Commerce

'We want to grow the sector, and need the confidence that, provided their surpluses generated are applied to further their social goals, and not for personal gain, the tax exemption can be counted on...'

B.I., lawyer

CRA's Non-Profit Organization Risk Identification Project Report's finale is a stated commitment to educate the NPO sector of its trespasses, to enable greater conformity with the CRA's stance. Our sense, in sharing CRA's position with workshop groups across BC, is that the information will not be accepted with gratitude. In fact, in our workshop delivery, the CRA position is met with the greatest levels of perceived injustice that we have ever encountered.

The BC Centre for Social Enterprise is itself a non-profit and a charity 'duct taped' together under an umbrella brand. This is because not all of our activities are charitable. As an example, our fee-for-service technical assistance and business planning services are situated within the non-profit. Starting in our 2010 tax year, based on the CRA rulings, we voluntarily relinquished our tax exemption. To our knowledge, we are the only non-profit to have done so. We file a regular corporate tax return, and pay corporate taxes.

Our own experience of relinquishing our tax exemption appears to demonstrate that the CRA is not prepared to handle tax-paying non-profits. Frontline CRA staff were not familiar with the rulings, so repeatedly gave us advice contrary to the official position of CRA. Once we crossed that hurdle and remitted payment, the tax department offered us the same ('incorrect') advice that the frontline folks had.

We are acutely aware that with the tax monies remitted, we could instead be offering more social enterprise supports to the sector. This is the rub: non-profits need resources retained within the organization, in order to sow the greatest impacts. Profit is a means to this end, not a purpose in itself.

In communications with CRA's Legislative Policy and Regulatory Affairs Branch and about the issue generally, we received this key comment by email:

'I fully agree that the [Income Tax] Act requires a special provision in order for social enterprises that are not charities to self-fund (i.e., raise money to subsidize appropriate activities) on a tax-exempt basis; for example, labour organizations have a specific provision. I have explained this to others as a 'hole' in the Act - whether or not it should be there is a question for Finance and Parliament, not CRA.'

This is to say that although CRA is the regulatory body, the shift that we wish to emerge rests with the federal Department of Finance. CRA's hands seem tied.

It is noteworthy that the NPO tax exemption rules have changed little since their introduction just under a century ago<sup>8</sup>.

And here is the improvement that we are advocating. We strongly urge the federal government to endorse the destination of profits test. Many in the non-profit sector believe that this test already exists, and by operating under this belief, they are currently jeopardizing their tax exemption.

The destination of profits test (or 'destination test' for short) is simply this: if the profits generated by a non-profit are redirected towards the organization to support it or to unleash more impacts based on its core community purposes, then the profits are tax-free.

In the long run, this would result in a non-profit sector that is:

- ✓ Confident and bold with respect to undertaking business activities
- ✓ Appropriately resourced
- ✓ Better skilled (i.e. able to afford wage levels that attract a more skilled labour force)
- ✓ Positively connected to government, business, and society
- ✓ Better poised to remedy some of the intractable issues of our time.

The destination test already exists in New Zealand. Their government is not concerned with where profits come from, but rather, where they go. This seems like a sensible position.

Our proposal does not represent a threat or constraint to the social enterprise capacity of registered charities. These already enjoy the ability to host related businesses within the organization, tax-free. Unrelated businesses can be housed in a taxable corporation, with income tax paid on only 25% of profits<sup>9</sup>. Further, charities benefit from greater grant access, and the ability to receipt donations.

Impacts of the current restrictive CRA rulings against intentional profit generation include these:

- ✓ In general, non-profits are not resourced enough to bring the CRA rulings to court – we know of only two such files that are in process;
- ✓ The just-completed CRA audit rounds represent a cost to the federal purse;

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<sup>8</sup> As expressed in the February 11, 2014 federal budget.

<sup>9</sup> In Canada, any corporation can donate up to 75% of its pre-tax profits to any charity. Unrelated businesses of charities typically donate 75% of their net profits to the parent charity, and only pay income tax on the remainder.

- ✓ The sector reports 'enterprise chill' (reluctance to engage boldly in social enterprise activities) due to the CRA rulings; and
- ✓ There are as many non-profits as charities in Canada – so the restrictions are effectively hobbling roughly half of the potential social enterprise actors in the community sector.

The cost to the government in enacting the destination test is difficult to determine, however we do know that the CRA audit rounds have cost taxpayers directly, and have perpetuated poor relations with the sector. Retracting the rulings will result in little lost revenue, as so many non-profits are offside now (i.e. foregone revenues are not an issue due to current non-compliance). Further, CRA may not have the mechanisms in place to collect income tax from non-profits at this time.

A more enabling position will complement Canadian exploration and introduction of hybrid legal structures for social enterprise (BC<sup>10</sup> and NS; review of the Canada Business Corporations Act is now underway), and emerging Social Impact Bond exploration activities from various branches of government. Both Employment and Social Development Canada and Industry Canada are interested in enabling the social enterprise sector, so philosophical congruence exists among departments.

Endorsing the destination test would maintain maximum resource levels within non-profits, enabling the greatest capital levels to be unleashed on our most wicked social and environmental challenges, ultimately resulting in a lessened reliance on shrinking government coffers.

We posit that enabling legislation would further legitimize social enterprise practice, resulting in expanded activity in this area, and thus, even greater capital to apply to the challenges faced by Canadians. This cycle of success will then perpetuate even greater social and environmental improvements.

CRA has passed their Non-Profit Organization Risk Identification Project Report on to the Department of Finance, which is currently framing a consultation framework. This will likely take the form of a position paper, with an attendant request for written feedback.

Convincing the NPO sector of the need to influence the current government position is not the challenge. The task at hand is to communicate the reality that a window of opportunity is about to open (via Finance's upcoming consultation) in which the force and magnitude of a unified and confident NPO sector voice supporting the destination test is likely the only means to effect the change that so many believe is already available to them now.

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<sup>10</sup> CRA has indicated to us (letter available upon request) that NPO ownership of the new Community Contribution Companies (C3's) in BC could signal profit intent, which would then result in loss of the parent NPO's tax exemption. CRA will determine whether the NPO would be offside on a case-by-case basis: which exposes the NPO to scrutiny if it is considering social enterprise activities through use of a hybrid, and hobbles the NPO's ability to work with nimbleness, as CRA's written response would take months to receive. Given CRA's stated position on the NPO / profit issue, it is unlikely that the ultimate response would be favourable.