Occasional Paper

Charitable Activities under the *Income Tax Act*: An Historical Perspective

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"The law of charity is a moving subject"
– Lord Wilberforce

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Named after the 1891 House of Lords decision, Commissioners for Special Purposes of the Income Tax v. Pemsel, [1891] A.C. 531, which established the four principal common law heads of charity used in Canada and elsewhere, The Pemsel Case Foundation is mandated to undertake research, education and litigation interventions to help clarify and develop the law related to Canadian charities. The Pemsel Case Foundation is incorporated under the Alberta Societies Act and is a registered charity.

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1. Introduction

In Canada's charitable sector, one of the enduring legal debates is whether an organization's activities can be interpreted as 'charitable' or 'not charitable', on their own and without any reference to the organization's formal purposes. The question has a definite bearing on whether an organization can be registered as a charity under the Canadian *Income Tax Act*, especially since the Act is sometimes interpreted as requiring a charitable organization to have exclusively charitable activities, independently of any otherwise charitable purposes.

2. The Issue

The Canada Revenue Agency sometimes takes the position that an organization's activities are not charitable, and therefore disqualifies that organization from being registered as a charity.

There is significant jurisprudential support to characterize a putative charity's activities as unacceptable under the following circumstances:

(a) The activity in question is materially significant and cannot be interpreted in any way as contributing to an charity's operations or the achievement of any of an organization's charitable purposes; or

(b) the activity in question, taken in context, has become so prominent in relation to the organization's overall operations, that it is reasonable to interpret it as an unwritten, and over-riding or at least coequal purpose of the organization, and this presumed purpose cannot be construed as charitable at law, or subservient to any other charitable purpose.

There are generally two cases where this does occur:

(a) where an organization, applying to be registered, proposes to involve itself in such activities; or

(b) where an organization has been registered as a charity, but where its operations have evolved over the years in ways that do not conform to the presumably charitable purposes for which it was registered.

In either of those cases, one can hardly object to a position taken by the Agency in its role as *de facto* regulator of the sector.

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In other cases however, the Agency arguably places an inordinate focus on activities, and uses this approach to proposed or existing activities, as justification to deny or revoke an organization's registration[1].

3. Discussion

One view that has a lot of currency in the Canada Revenue Agency is that section 149.1 of the *Income Tax Act* which regulates registered charities frequently refers to the term 'charitable activities'. According to the proponents, this justifies conflating the notion of activities with that of purposes, especially when it comes to charitable organizations.

In particular, the current subsection 149.1(1) of the Act defines a charitable organization as...

> an organization, whether or not incorporated,
>
> all the resources of which are devoted to charitable activities carried on by the organization itself...[2]

Other subsections of 149.1 use the term 'charitable activities' to distinguish them from that same organization's other activities. In its policy pronouncements, in the design of its information returns[3] and in its decisions, the Agency has often tried to parse 'charitable activities' from an organization's 'other' activities – presumably the ones that would be administrative, fund-raising, political, business, investment, or just 'non-charitable' activities – in an attempt to curtail perceived or real abuse of charitable assets. Letters from the Agency will frequently state that an organization has to meet both a 'purposes' and an 'activities' test.

However, this practice of using the statute to attribute a charitable (or non-charitable) character to activities on their own produces incoherent results. In principle, if this approach holds true and therefore if a charitable organization has to devote all its resources to charitable activities by law, how can it possibly incur administrative, business, or fund-raising expenses? Where does the 'charitableness' of an activity end, and the 'administrative' or 'managerial' character of that activity become preponderant?

Or to turn the question around, how can a charitable organization be registered if its fund-raising activities are not considered "charitable'? Why does section 149.1 of the *Income Tax Act* require a charitable organization to devote all its resources to charitable activities? What happens if an activity can achieve a charitable purpose, but could arguably also satisfy another unstated but non-charitable purpose? How can we impress a charitable or non-charitable character to an activity without reference to a purpose?

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[1] See for instance, the summary policy on charitable activities that are contrary to government policy (CSP-P13); the Guidance on Arts Activities and Charitable Registration (CG-018); the Guidance on Community Economic Development Activities and Charitable Registration (CG-014); and the Guidance CG-013, Fundraising by Registered Charities.

[2] R.S.C. 1985, (5th supp), as amended.

[3] See for instance lines 5000, 5010 and 5020 of Form T3010, the *Registered Charity Information Return.*

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Part of this quandary has been addressed by Canadian courts. Most importantly, in *Vancouver Society of Immigrant and Visible Minority Women*[4], Iacobucci, J., writing for the majority of the Supreme Court of Canada, stated:

> While the definition of "charitable" is one major problem with the standard in s. 149.1(1), it is not the only one. Another is its focus on "charitable activities" rather than purposes. The difficulty is that the character of an activity is at best ambiguous; for example, writing a letter to solicit donations for a dance school might well be considered charitable, but the very same activity might lose its charitable character if the donations were to go to a group disseminating hate literature. In other words, it is really the purpose in furtherance of which an activity is carried out, and not the character of the activity itself, that determines whether or not it is of a charitable nature. Accordingly, this Court held in *Guaranty Trust*, supra, that the inquiry must focus not only on the activities of an organization but also on its purposes.[5]

It appears the Court may have been stumped by this problem. In fact, its comments are diametrically opposed to the Canada Revenue Agency's thinking. Unfortunately, because of the context of the appeal, the Court did not try to unravel the matter or engage in any discussion of the Agency's practice of parsing out an organization's various activities.

Still, for the Agency, writing a letter to solicit donations for a dance school does not appear to be a 'charitable activity'[6]. One only has to peruse its policies and documents to witness the importance it gives to the notion of 'charitable' and 'non-charitable' activities. However, we may be able to clarify this problem for the benefit of all concerned, and come to a better understanding of the relevant provisions, their meaning, and how this meaning has come to be distorted over time, by examining the history of the provisions.

Prior to the establishment of a registration process for charities in 1967, and before the subsequent major revision of the entire *Income Tax Act* in the early 1970s, charities were defined in the following way. For clarity's sake, I have taken the liberty of underlining the material portions of the excerpts.

Paragraph 62(1)(e) of the then *Income Tax Act*[7] defined a charitable organization as an organization...

> whether or not incorporated, all the resources of which were <u>devoted to charitable activities carried on by the organization itself</u> and no part of the income of which was payable to, or otherwise available for the personal benefit of any proprietor, member or shareholder thereof.

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[4] 1998 S.C.R. 10.

[5] At paragraph 152.

[6] See paragraph 3 of the Guidance on Fundraising Activities by Registered Charities, for instance.

[7] 1952 R.S.C. c.148, as amended.

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Paragraph 62(1)(f) of the Act defined a (charitable)[8] non-profit corporation as...

> a corporation that was constituted exclusively for charitable purposes, no part of whose income was payable to, or otherwise available for the personal benefit of, any proprietor, member or shareholder thereof, that has not since June 1, 1950, acquired control of any other corporation, and that, during the period,
>
> (i) did not carry on any business,
>
> (ii) had no debts incurred since June 1, 1950, other than obligations arising in respect of salary, rents and other current operating expenses, and
>
> (iii) except in the case of a corporation that was, before the 1st day of January, 1940, constituted exclusively for charitable purposes, expended amounts each of which is
>
> A. an expenditure on charitable activities carried on by the organization itself,
>
> B. a gift to an organization in Canada, the income of which for the period is exempt from tax under the present Part by virtue of paragraph (e),
>
> C. a gift to a corporation resident in Canada the income of which for the period is exempt from tax under this Part by virtue of this paragraph, or
>
> D. a gift to Her Majesty in right of Canada or a province or to a Canadian municipality, and
>
> the aggregate of which is not less than 90 per cent of the corporation's income for the period.

Paragraph 62(1)(g) of the Act defined a charitable trust as...

> a trust all the property of which is held absolutely in trust for charitable purposes, that has not, since June 1, 1950, acquired control of any corporation, and that, during the period,
>
> (i) did not carry on any business,
>
> (ii) had no debts incurred since June 1, 1950, other than obligations arising in respect of salary, rents and other current operating expenses, and
>
> (iii) expended amounts each of which is
>
> A. an expenditure in respect of charitable activities
> B. a gift to an organization in Canada the income of which for the period is exempt from tax under this Part by paragraph (e), or
> C. a gift to a corporation resident in Canada the income of which for the period is exempt from tax by virtue of paragraph (f) and

[8] In contradistinction to paragraph 62(1)(i) which defines a 'regular' non-profit organization as "a club, society or association 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 otherwise available for the personal benefit of, any proprietor, member or shareholder thereof."

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> the aggregate of which is not less than 90 per cent of the income of the trust for the period.

It is immediately apparent from the overall structure of these three definitions that the expression "charitable activities carried on by the organization itself" is intended to distinguish how charitable funds are to be applied by each type of charity. Paragraph (f) refers also to "...charitable activities carried on by the organization itself", and paragraph (g) refers to "an expenditure in respect of charitable activities".

However, in contrast to charitable organizations, charitable non-profit corporations and charitable trusts could use their funds on their own relief programs or they could also transfer funds to charitable organizations. In the same way, charitable trusts could transfer funds to charitable non-profit corporations, but could not in turn receive funds from these same corporations.

The reverse however was prohibited: the wording of paragraph 62(1)(e), "carried on by the organization itself", read together with the wording in (f) and (g) that allowed corporations and trusts to give to charitable organizations was intended to prevent charitable organizations from funding charitable non-profits and charitable trusts, and presumably from circulating funds endlessly without using them for charitable relief.

The 1966 *Report of the Royal Commission on Taxation* dealt primarily with the taxation or tax exemption of charities, and not so much with the rules regulating charities under the *Income Tax Act.* But tellingly, it summarized the applicable legislation in the following words:

> The present general exemption from income tax for charitable organizations is contained in paragraphs (e), (f) and (g) of section 62(1) of the Act. Paragraph (e) exempts charitable organizations, whether or not incorporated, all the resources of which are devoted to charitable activities carried on by the organization itself; paragraphs (f) and (g) respectively, exempt charitable corporations and charitable trusts, each of which must meet certain stipulated requirements, and which may act as conduits for distributing funds to charitable organizations[9].

The major revision of the *Income Tax Act* in the early 1970s[10] brought no major change to these provisions.[11] However, the Act was again amended[12] in 1974, and the relevant provisions migrated to subsection 149(1).

At that time, subsection 149(1) read:

> (1) No tax is payable under this Part upon the taxable income of a person for a period when the person was
>
> (f) a charitable organization whether or not incorporated, all the resources of which were devoted to charitable activities carried on by the organization

[9] *Report of the Royal Commission on Taxation,* 1967, Queen's Printer, volume 4, pp. 128 and ff., at p. 131.

[10] 1970-71-72, S.C., c. 63.

[11] Note the slight change to s. 149(1)(h)(iii)A. which brings it more in line with the wording in the other provisions.

[12] 1974-75, S.C., c. 26, s. 103(1) and (2).

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itself and no part of the income of which was payable to, or otherwise available for the personal benefit of any proprietor, member or shareholder thereof.

(g) a corporation that was constituted exclusively for charitable purposes, no part of whose income was payable to, or otherwise available for the personal benefit of, any proprietor, member or shareholder thereof, that has not since June 1, 1950, acquired control of any other corporation, and that, during the period,

(i) did not carry on any business,
(ii) had no debts incurred since June 1, 1950, other than obligations arising in respect of salary, rents and other current operating expenses, and
(iii) except in the case of a corporation that was, before 1940, constituted exclusively for charitable purposes, expended amounts each of which is
A. an expenditure on charitable activities carried on by the corporation itself, or
B. a gift to any donee described in paragraphs 110(1)(a) and (b), and

the aggregate of which is not less than 90 per cent of the corporation's income for the period.

(h) a trust all the property of which is held absolutely in trust for charitable purposes, that has not, since June 1, 1950, acquired control of any corporation, and that, during the period,

(i) did not carry on any business,

(ii) had no debts incurred since June 1, 1950, other than obligations arising in respect of salary, rents and other current operating expenses, and

(iii) expended amounts, each of which is
A. an expenditure on charitable activities carried on by the trust itself, or
B. a gift to any donee described in paragraph 110(1)(a) or (b), and

the aggregate of which is not less than 90 per cent of the income of the trust for the period.

These amendments essentially replicate the former provisions while adding some new recipients, namely Canadian municipalities and others. Note that charitable organizations still cannot transfer funds to other charities or other donees described in paragraphs 110(1)(a) and (b).

The 1975 Discussion Paper, *The Tax Treatment of Charities,* released by the Department of Finance[13] was also of the view that the wording of the definition of a charitable organization in s.

[13] Department of Finance, June 23, 1975.

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149.1 was intended to distinguish these organizations from other kinds of charities and determine how charitable funds should be expended. In paragraph 8, it stated the situation at the time thus:

> More than 90 per cent of the registered charities are in fact organizations under paragraph 149(1)(f) of the *Income Tax Act*. These organizations may take varying legal form (sic). They must devote all their resources to charitable activities they themselves carry on. The transfer of money by one of those organizations to another charity is not considered a charitable activity for the purposes of the *Income Tax Act*.

At paragraph 9, it went on to state:

> As practice has developed in Canada over the years, most charitable corporations and charitable trusts are fund raisers, transferring the money raised or earned to other charities. Most direct charitable activity is carried on by charitable organizations.

And at paragraph 11, the authors of the Paper repeated:

> At present, charitable organizations are not allowed to distribute funds to other registered charities because this would detract from their role in carrying on direct charitable activities.

The Discussion Paper went on to recommend that charitable organizations be allowed to distribute up to 50 percent of their annual income to other registered charities and qualified donees, and accordingly, after a subsequent Budget Paper, *Charities under the Income Tax Act*[14], the above definitions were repealed[15], with the exception of the definition of a charitable organization which, importantly for this discussion, remained essentially the same. The former definitions of a charitable non-profit corporation and a charitable trust however were replaced with a single definition – that of a charitable foundation[16]:

> "Charitable foundation" means a corporation or trust constituted and operated exclusively for charitable purposes, no part of the income of which is payable to, or is otherwise available for, the personal benefit of any proprietor, member, shareholder, trustee or settlor thereof and that is not a charitable organization.

At the same time, the Act was amended to allow all charities registered under the *Income Tax Act* – foundations and organizations alike – to transfer funds to what would later become 'qualified donees'. These included other registered charities.

What this brief history tends to show is that the wording of the definition of a charitable organization in the *Income Tax Act* was in no way intended as a substantive test for registration purposes by requiring the supervisory body to determine whether an organization's activities were 'charitable' in their own right. Instead, it appears the whole structure was intended as a complete system, preventing the channeling of funds from often loosely-constituted organizations to charitable corporations or trusts, and ensuring instead that they flowed toward

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[14] Department of Finance, Budget Paper D – Charities Under the Income Tax Act, May 25, 1976.

[15] 1976-77, S.C., c. 4, s. 59(1).

[16] Paragraph 149.1(1)(e).

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relief programs. Charitable organizations were conceived essentially as the 'do-ers', the prime deliverers of relief programs[17].

This is to be distinguished from the comments of the Supreme Court of Canada in *Guaranty Trust Company of Canada v. Minister of National Revenue*[18]*,* and that case does not detract from the statutory scheme under discussion. The use of an activities test, as explained by the majority decision in *Guaranty Trust* was as a means of determining whether the objects of the trust continued to be charitable, not as a stand-alone test in its own right. The objective in assessing the activities was to determine whether the operations of the trust had evolved since its creation in ways that created a collateral, if unstated purpose. It still remains that if activities can be construed as reasonably leading to the attainment of an existing charitable purpose, they cannot be taken on their own, and assigned a non-charitable character in isolation.

The possibly unintended result of the 1976-77 amendments in failing to address the wording in the definition of a charitable organization while inserting another provision allowing these same charitable organizations to transfer funds to other charities and other 'qualified donees' contributed to creating a perception, in combination with the introduction of a 'disbursement quota', that the Act's reference to 'charitable' activities was deliberate and that it allowed Revenue Canada (as it then was) to characterize activities as 'charitable' or 'not charitable' independently from an organization's stated purposes. But if this is the case and the definition of a charitable organization was intentionally left 'as is', the reasoning simply leads to contradictions rather than to a logical interpretation of the Act.

4. Conclusion

In satisfying the requirements for registered charity status, the term "all the resources of which are devoted to charitable activities carried on by the organization itself" must be interpreted in context, in particular as it relates to its genesis. Moreover it should be interpreted in a way which produces a logical result rather than in ways that produce conflicting ones. And finally it ought to be assigned the same meaning throughout s. 149.1. The only way a consistent meaning can be ascribed to the expression "all the resources of which are devoted to charitable activities carried on by the organization itself" is as an operational description of the organization's work, not as an independent and substantive qualifying test for the purpose of registration.

Assuming the above interpretation is correct, the extent to which it should impact policies within the Canada Revenue Agency will have to be the object of further research. In particular, there needs to be an overall analysis of how an organization's activities should affect its registered status pursuant to case law as well as under the *Income Tax Act*.

There also needs to be a further exploration of the term 'charitable activities' notably in the context of the disbursement quota. This has not yet been addressed by the courts, but while the term 'charitable activities' seems to be synonymous with 'program delivery', its application is not without its own problems, since both the regulator and registered charities are expected to determine which resources are applied to the delivery of charitable programs, and which resources are used for other reasons.

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[17] 1967 S.C.R. 133, at p. 144 and ff.

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There are circumstances where it is legitimate to focus on activities if we are to determine a charity's true purposes. But in other cases where an organization's activities can be reasonably construed as achieving or contributing to achieve a charitable purpose, it is incorrect at law to characterize them otherwise in isolation when determining whether that organization should be registered as a charity.

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