



The Pemsel Case

FOUNDATION

Submission to the Senate Special Committee

on the Charitable Sector

Senate Appearance

October 22, 2018

The Pemsel Case Foundation

Suite 1150 – 10060 Jasper Avenue

Edmonton, AB T5J 3R8

Telephone: 780 425-5356

Facsimile: 780 425-0282

Summary

The Pemsel Case Foundation recommends that the Senate Special Committee on the Charitable Sector endorse the following **immediate reforms** of the federal *Income Tax Act* framework governing registered charities:

- Consolidate the current categories of registered charity to be two: public and private charity;
- Eliminate, or streamline, the current purposes/activities distinction in the *Income Tax Act*, and define and identify impermissible conduct primarily through statutory provisions;
- Move registration and revocation appeals to Tax Court and set out appeal protocols and evidentiary standards in legislation; and
- Replace the registered charity “*direction and control*” requirements with rules, such as “expenditure control” which we think would facilitate both the work of charities and the Charities Directorate.

Matters that Pemsel thinks **require further study** to determine how to proceed include:

- Scope of *Income Tax Act* registration eligibility in Canada;
- Qualified donee classification; and
- Non-profit organization regulation.

Introduction

The Pemsel Case Foundation fosters better knowledge and understanding of charity law and regulation through research, education and, where appropriate, court appearance. Established in 2010, it is a society under the Alberta *Societies Act* and a registered

charity under the *Income Tax Act (ITA)*. Pemsel's Board and authors have considerable experience in charity and tax law. The Directors have long and wide experience in Canada, the United States, England and Australia as practising lawyers, in government regulation of charities and as academics.

Pemsel's view is that the existing *ITA* regulatory regime for registered charities is overly complex and burdensome. The provisions unnecessarily limit innovative approaches to address contemporary social, economic and cultural issues. As one charity leader has put it "*I ought to be able to do my work without having a lawyer on one side of me, and an accountant on the other side.*"

Several changes to key provisions would significantly reduce the compliance burden for charities and free them to better contribute to Canadians' quality of life, without sacrificing the necessary oversight role of government where tax preferences are available. Pemsel also thinks that these changes could be made without compromising the existing safeguards on tax expenditures. A streamlined statutory framework would help to simplify the compliance process for the Charities Directorate at Canada Revenue Agency (CRA).

Why the need for change?

A New Presence of the *Charter*

The need for reform is newly urgent. A recent court case has significantly applied the *Canada Charter of Rights and Freedoms* (*Charter*) to the federal charity regulatory regime. Part of the *ITA* dealing with charities was struck down as unconstitutional. Unusually, this case's *Charter* consideration is the first significant application to registered charity regulation of the *Charter* since it came into force.

The government has said it will appeal the decision. And it has committed to revamp the provisions. Whatever the outcome on appeal, this case will very likely see other *ITA* charity rules being subject to challenge. Legislative reform could address potential *Charter* issues with current charity provisions. In so doing, uncertainty and cost for both the regulator and the sector in managing possible future constitutional challenges could and should be reduced.

Resources to Address the Purposes of Charity

There is the problem of finding financial resources for the charitable sector over the medium-and long-term. Pemsel endorses the analysis of Brian Emmett, the Chief Economist for Canada's Charitable and Non-profit Sector,¹ who has identified a looming gap on the order of tens of millions of dollars in addressing Canadians' social, economic and cultural needs and the ability of the sector to meet those needs.

¹ Brian Emmett, Chief Economist for Canada's Charitable and Non-profit Sector, appeared before the Senate Special Committee on the Charitable Sector on May 7, 2018 and discussed his work in this area. See, especially, *Charities, Sustainable Funding and Smart Growth: Discussion Paper* (Imagine Canada, 2016).

We think that regulatory regime changes are a crucial first step in dealing with this coming deficit.

We submit that the statutory and administrative update of the federal *ITA* is essential if measures to enhance donating and volunteering are to be effective. The *ITA* rules for charities are key and central. They are not a competing priority or an independent concern. They are the framework on which all else relies.

The current system is both closed – organizations are either in or out – and one in which it is difficult for both organizations and the regulator to delineate the boundaries. To the extent that groups or charitable programs are thwarted because the sector can't understand the system or because the regulator is itself uncertain and risk averse, opportunities to improve Canadians' quality of life are lost.

In the 1930s, when Parliament enacted a tax-assistance charity regime based on the common law, it brought forward a system intended to be dynamic and one that could and would evolve to meet changing times. Over the years, the charities' provisions of the *ITA* have been altered in a variety of ways to confront issues. What has not been considered is how well all the many pieces that now make up the regime function. Many observers think the system is overly cumbersome and ill-suited to responding to the pace of change in today's world. Pemsel thinks:

- (A) legislative change is urgently needed in four key areas; and
- (B) a review of several other issues needs to be done.

Immediate reforms

There are four regulatory areas where Pemsel submits that changes could be made in the short term. Immediate improvement of the regulatory framework governing registered charities could be made by:

- 1. Consolidating the current three categories of registered charity** – charitable organization, public foundation and private foundation – into two types based on whether the charity is closely-held or widely-held, with the appropriate degree of regulation turning primarily on that criteria;
- 2. Reforming the current purposes/activities distinction in the *ITA*** – and where for tax policy reasons conduct (such as certain business or political initiatives) is regulated, explicitly defining what is unacceptable or restricted;
- 3. Moving appeals of registration and revocation decisions from the Federal Court of Appeal to the Tax Court**, and giving the Courts broader authority to gather additional evidence and substitute their decision for that of the regulator; and
- 4. Eliminating the “own activities” language** in the *ITA* definition of a charitable organization, and **replacing the Canada Revenue Agency’s direction and control requirements**, with a due diligence and risk management requirement for charities that deliver programs through

groups that are not registered charities. This approach is used with success in the U.S.

Areas requiring further study

In addition, there are three other areas that should be further studied. Changes here will ensure Canada is well positioned to meet the challenges ahead and keep pace with other jurisdictions and evolving societal needs. These are:

1. The common law meaning of charity should be reviewed to determine whether legislation ought to be enacted to broaden the meaning. Under the *ITA* regime, there is little opportunity to modernize the meaning of charity through consideration by a court – the dynamic of the common law approach. This results from the expense of getting to the Federal Court of Appeal (FCA), from appeals being restricted to evidence previously in the CRA record, and from the infrequency of the FCA overturning administrative decisions, which are themselves on a narrow range of matters;²

2. The current concept of “qualified donees ought to be reviewed.” Certain entities identified in the *ITA* are eligible for tax privileges. But they are distinct from registered charities. It is worth considering whether some types of registered charities – for example, organizations that are already heavily regulated like hospitals and post-secondary

² Many issues in the contemporary context for the work that registered charities’ do has never been dealt with by the FCA, including social media, crowd funding and inter-organizational collaboration. This leaves

institutions – ought to be moved to this category. What should be the appropriate tax treatment for some emerging groups – for example, non-profit social enterprises or non-profit journalism organizations? Should their tax treatment be no preference, qualified donee status or another approach? More broadly, a review ought to consider how the concept of “qualified donee” should fit within the regulatory scheme as well as the merit of different treatments for different types of qualified donees.

3. The appropriate treatment and regulation of non-profit organizations (NPOs) under the *ITA*, and the differentiation between these groups and registered charities ought to be comprehensively studied. A study in this area should take recent discussions of social enterprise into account and consider how these entities potentially relate to NPOs and registered charities. Currently the *ITA* draws no distinction between public benefit and member benefit NPOs or between closely-held and widely-held NPOs. As well, there are minimal *ITA* reporting requirements for NPOs and there is no transparency for what is reported.

Details of Issues for Immediate Change

More specifically, with respect to the areas where we advocate immediate change:

many areas without clear rules.

Types of charities – Public charities would be those that are widely-held based on funding, membership and governance criteria. Private charities would be those that are closely-held based on source of funding, membership and governance criteria. Broadly, public and private charities ought to be subject to the same basic regulatory measures, with additional regulation of private charities to prevent clandestine mischief and self-dealing.

Purposes/activities – Purposes ought to be the cornerstone of registering and regulating charities. Currently there is tension between the common law's focus on purposes and *ITA* provisions that deal with activities. The problem is that an activity may be different when viewed in the context of its purpose than when viewed in the context of *ITA* legislation. To address this, the relationship between regulation under common law and regulation under statutory provisions ought to be explicitly set out in the legislation. Legislative constraints to prohibit or limit types of conduct ought to be based on narrow definitions and precise tests.

In designing these constraints, it needs to be kept in mind that quantitative criteria – such as the much impugned 10% test for political activities – are apt to conflict with the common law assessments of charitability based on qualitative criteria. The concept of activities, if used at all, should describe highly specific conduct, and should not be used to determine eligibility for registration.

Statutory provisions that constrain charities' involvement in partisan political conduct, revenue generation from operations that are not

furthering their purposes, inappropriate fundraising, and other such endeavours should be easy to understand and administer. In most circumstances, common law rules simply require a charity to operate in furtherance of one or more of its charitable purposes. A key element of this is that the activities that a charity carries out must be a means to achieving its charitable purposes, rather than ends in themselves.

Measures that have the effect of micro-managing how a charity does its work are essentially at odds with this approach. Provisions addressing activities should be rare and enacted only where they can be justified for explicit tax policy reasons. Alternate measures that require transparency and encourage good governance practices are generally the best mechanisms to address peripheral inappropriate conduct in a charity's operations.

Provisions considering activities should recognize that, with limited exceptions – for example, a prohibition of partisan political conduct – the common law allows wide scope in what a charity can do. Activity prohibitions must, therefore, be precise, and clear.

Consideration might be given to including in the *ITA* a provision like that found in New Zealand legislation, which recognizes that a charity can have a minor non-charitable purpose where it is “ancillary, secondary, subordinate, or incidental” to a charitable purpose. Minor purposes that don't meet the exclusively charitable criteria can disqualify groups from status. This would provide further certainty that removing activities-focused *ITA* provisions would not give charities an

unfettered ability to engage in conduct beyond that tied to its *bona fide* charitable purpose.

Registration/revocation appeals – At common law, it is well-established that charity is “a moving subject.” It should be allowed to change and adapt to reflect the evolving values and characteristics of society. The current state of the appeal process – focusing only on registration or revocation – has led to the meaning of charity in Canada being frozen in the past. As well, the processes is prohibitively expensive, mired in administrative law concepts, and has failed to promote the development of a coherent and analytically-sound body of case law. It is said that the legal meaning of charity in Canada at the federal level has been unduly influenced by concerns over tax expenditure.

While some have argued that the CRA should be more willing to evolve the meaning of charity through administrative practices, there are clear limitations on how far the regulator can go in the absence of common law or statutory support – knowing where the boundaries of the closed system are found – goes some way, no doubt, to explain CRA’s traditional risk aversion in this field.

Moving registration and revocation appeals to Tax Court is a potential solution to the judicial aspect of this problem. Another, or additional, option may be to authorize test cases in the courts. As well, legislative provisions specifically providing for a trial *de novo* and prescribing evidentiary standards on appeals would be helpful.

Direction and control – Existing *ITA* rules and policies regulating how charities can deliver programs through intermediary organizations are more restrictive than those of other jurisdictions. Moreover, they are at odds both with contemporary approaches to international development – including practices encouraged by Global Affairs Canada – and to working with marginalized communities in Canada.

The rules in this area is not easily understood. They foster unintentional non-compliance. Their complexity has led both CRA and the sector to become risk averse, inhibiting innovation. The policy objective of protecting against misuse of tax-subsidized charity assets, while reasonable, could be achieved by adopting the U.S. expenditure control model. This ought to be explored as an alternative. Additionally, relaxing provisions dealing with gifts to non-qualified donees should be examined.

Details of Issues for Further Study

About the matters Pemsel thinks need further study, we make the following observations:

Scope of eligibility for *ITA* registration – Updating the scope of charity/qualified donee eligibility should be examined so that it better reflects the realities of Canadian society. Pemsel has not researched what might be included in a contemporary treatment of eligibility, but we think that there is a significant shift underway. This movement stems from many factors, including the accelerating pace of technological change and the exponential growth in the influence of social media. Accompanying this change are a host of complex issues,

among them increasing economic inequality, environmental degradation, climate change, rapid displacement of traditional industries and their workforces and the spread of terrorism. There will be significant pressure on the charitable sector to play a role in dealing with some of these matters. Clear lines on what is in or out – the boundaries – on these matters demand new or renewed attention

To be credible and widely-supported, any update to the meaning of charity must be managed with research and a consultation process. Pemsel's research indicates that there are advantages and disadvantages to statutory definitions when compared to a continuing reliance on the common law. But we continue to think that relying on the common law is preferred. Providing an accessible and responsive judicial and administrative process would encourage the meaning of charity to evolve in keeping with societal values and norms. A similarly focused legislative model is undesirable, both because it would be difficult to administer and because regulatory uncertainty would most likely undermine organizational effectiveness.

Qualified donee classification – The qualified donee designation provides a flexible means for tax-subsidizing and monitoring conduct traditionally not within the realm of Canadian charity. Current examples of qualified donees are:

- registered arts service organizations,
- registered Canadian amateur athletic associations, and
- certain low-cost housing corporations for the aged.

Currently there is no policy framework for the various sub-categories of qualified donees. The addition of new sub-categories does not appear to be driven by any overarching vision. In contrast, under the U.S. system there has been a deliberate choice to develop multiple classifications for exempt organizations, and to apply different rules to them according to the purpose and needs of a specific category.

The U.S. model allows different policy goals to be advanced through creation of various categories of tax-exempt organizations. A study of the policy considerations related to qualified donee status could assist in rationalizing the treatment these entities receive and provide an opportunity to consider whether additional classifications ought to be established – potentially as an alternative to expanding the meaning of charity through legislation.

NPO regulation – This is a complex topic. It ought to be kept separate from registered charity regulation. The two types of organizations have distinctly different origins and imperatives. The absence of *ITA* distinctions between public benefit/member benefit and closely-held/widely-held entities noted above, and the recent emergence of social enterprise as a new category of entity suggest that extensive further study is needed before definitional issues can be resolved and an appropriate regulatory framework can be developed.

Conclusion

The Pemsel Case Foundation thanks the Senate Special Committee on the Charitable Sector for the opportunity to make this submission and

would be pleased to follow-up if there are any questions arising from our brief.