

Registered Charities and Business Activity: **A need for objective perspective and practical examination**

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Introduction

There is continuing narrative regarding Canada Revenue Agency (CRA) regulations specific to registered charities operating business activity. The general feeling seems to be a need to relax or seemingly eliminate restrictions through the introduction of a Destination of Profits test¹, expansion of the Related Business rules², and/or a recommendation that legislation focus on charities' purposes rather than on activities³. Stagnant or decreasing funding and donations, and interest in the social enterprise concept, and the apparent barriers to its operation by registered charities, appears to be the primary drivers of this conversation.

In my view, a discussion of potential changes to regulations should be done wearing a lens of impartiality rather than a traditional advocacy hat. This makes the starting point an objective and practical review of relevant CRA policy as opposed to an emotive appeal to open up streams of revenue, ones that are potentially being denied due to outdated and/or unnecessary constraints, which tends to place social good above all other considerations.

This article will deal only with the regulatory environment for registered charities. Non-profit organizations (NPOs) that do not have charitable status are often included in this dialogue but this lacks recognition of the different regulations NPOs operate under which, unlike charities, does not hold them accountable for delivering public benefit. However, in general, the points discussed here should also apply to NPOs.

Registered charities are afforded the privilege, rather than the entitlement, of tax-exempt status accompanied by the ability to issue receipts for gifts. They are conferred this status as their purposes are different, if not opposite, philosophically from for-profit entities. Fundamentally, they exist for public benefit and do not operate with an intention to make profit, which in theory means they would not be earning income that needs to be taxed. Public trust in charities, supported by CRA's regulatory oversight, allows for billions of dollars of government funding and donations to be directed towards charities in the belief it will be used for charitable purposes.

Registered charities are essentially public entities that are stewarding what are essentially public assets towards charitable ends. I believe citizens and businesses who pay taxes should be viewed as default

¹ <https://www.muttart.org/wp-content/uploads/2018/10/Muttart-Submission-Oct.-2018-1.pdf> (page 30)

² https://www.marsdd.com/wp-content/uploads/2014/09/MaRS-National_Advisory_Board_Report_EN.pdf (page 15)

³ Report of the Consultation Panel on the Political Activities of Charity (Recommendation #4)
<https://www.canada.ca/en/revenue-agency/services/charities-giving/charities/about-charities-directorate/political-activities-consultation/consultation-panel-report-2016-2017.html>

supporters of the charity sector regardless of whether they make donations or engage in volunteerism. This means the success of the charity sector is a group effort by the Canadian public as a whole rather than from those directly associated with the sector itself. I believe this is represented in CRA policy for charities with its encouragement of financial engagement by the public and in the rules specific to business activity which maintains an even playing field between charities and tax-paying entities.

Potentially making that playing field uneven needs to be approached pragmatically as taxpaying corporate entities and individuals should be protected against unfavourable tax regulations. Potential unfairness is not necessarily attributed to charities being exempt from paying taxes on business income but rather on the introduction of competition in the marketplace which could be artificially supported by donations and funding. The evenness of the playing field among charities also needs consideration. These dynamics will be discussed in greater detail after a review of the current regulations.

Overview of Current CRA policy

There are four distinct contexts that charities can sell goods and services as identified in CRA's What is a Related Business policy⁴:

1. In the delivery of a charitable program as a fee-based program (e.g. rent in low-income housing programs, university tuition fees, museum admission) or one of two employment-themed programs - a *Training Business* or a *Social Business for Persons with Disabilities*
2. As a fundraising initiative subject to CRA's fundraising guidance (e.g. a lottery, a bake sale, or the sale of donated goods like used clothing or unused construction materials)
3. As a 'business', as defined by CRA, that falls under the Related Business rules. This includes a business run by volunteers or in one of the four forms of linkages identified by CRA (e.g. hospital parking lots and gift shops)
4. As an unrelated business; a 'money generator' for a charity (i.e. serves no other purpose other than to earn potential profits to be directed to the charity for use on its charitable programs) that would have to be housed in a wholly owned subsidiary

From my interpretation, an activity that fall into **Category #1** is not considered a 'business' so long as the intention is to meet charitable goals rather than trying to generate profit. For a fee-based program, this means operating in a cost-defraying manner (i.e. establishing a fee structure based on an estimate of costs and consumer usage) rather than intentionally trying to make a profit beyond what would be could considered a reasonable unintentional or incidental profit to manage the program in a fiscally responsible manner. For an employment-themed program, this means focusing on helping beneficiaries (i.e. the charitable end) rather than on making an intentional profit to be used elsewhere by the charity.

I believe the policy makes logical sense and have not heard any arguments that directly challenge why a switch from a charitable objective to intentionally generating profits would not compromise charitable ends. I believe this concept is not well understood within the sector and perhaps should be given

⁴ <https://www.canada.ca/en/revenue-agency/services/charities-giving/charities/policies-guidance/policy-statement-019-what-a-related-business.html>

clearer direction in CRA policy to distinguish between intentional and unintentional profit, and on appropriate allocation of administrative expenses.

Examples of fee-based charitable programs are often described as a charity running a ‘business’ in narrative despite being identified by CRA as charitable. This mistaken labeling has led to discussion about the fairness of charities operating businesses in competition with for-profits who are not exempt from taxes⁵. I believe this a moot point as, in theory, a fee-based charitable program is meeting a community need for a good or service not available in the marketplace thus should not be in direct competition with for-profit providers. A charitable training business such as a café could operate in direct competition with a for-profit business but this is deemed to be acceptable as the purpose of the activity is to further a charitable purpose.

Another example of mistaken labelling is the sale of donated goods mentioned in **Category #2** despite CRA policy specifically stating it is not a business. Similarly, soliciting donations is also not considered a business. I believe potential elimination of the current legal limitations on fundraising with the introduction of a Destination of Profits test or a switch to focus on charities’ purposes is problematic. I have outlined concerns specific to this in a separate article⁶.

Related Business (**Category #3**) is often viewed as a potential legal opening for charities to operate unrelated businesses (**Category #4**). Charity programs in **Category #1**, especially employment-themed programs, are sometimes mistakenly described as a Related Business in narrative which is understandable given that “Business” is included in the CRA policy program names. Nevertheless, it should be clear that there are fundamental differences between the identified linkages of a Related Business, and the subordinate stipulation that accompanies them, and a ‘money generator’ business or a fee-based charity program.

In a Destination of Profits test discussion, **Category #1** needs to be assessed independently of **Category #4** where the goods and services being sold have no connection (my term) or association with a charity’s purposes. A MaRS Centre for Impact Investing report appropriately separates activities that would fall into **Category #4** which they describe as “only complementary to the organization’s programs and/or objectives insofar as they provide a source of revenue that is used to advance these programs and/or objectives”⁷.

What is lacking in this report, though, is the recognition other revenue generating activities fall under other distinct CRA policy, most notably an activity that would fall into **Category #1** – a fee-based or employment-themed charity program. This distinction also appears to be absent in Muttart Foundation’s submission to the Special Committee of the Senate on the Charitable Sector⁸ and in the Employment and Social Development Canada’s *Recommendations of the Social Innovation and Social Finance Strategy Co-Creation Steering Group*⁹. Instead, fee-based and employment-based

⁵ <https://thephilanthropist.ca/2019/01/unfair-or-unwanted-competition-between-charities-and-for-profit-businesses-in-canada/pdf/>

⁶ <https://charityinfo.ca/articles/BadFundraising>

⁷ https://www.marsdd.com/wp-content/uploads/2014/09/MaRS-National_Advisory_Board_Report_EN.pdf (page 15)

⁸ <https://www.muttart.org/wp-content/uploads/2018/10/Muttart-Submission-Oct.-2018-1.pdf> (page 28)

⁹ <https://www.canada.ca/en/employment-social-development/programs/social-innovation-social-finance/reports/recommendations-what-we-heard.html> (section 3.4)

charity programs are called “businesses” which adds confusion to the discussion surrounding business activities.

The frequent use of the terms ‘earned income’ and ‘social enterprise’ in narrative, both of which lack formal legal definition, also adds to this confusion. In regards to the social enterprise concept, it needs to be noted that all four categories listed above can fall into the very broad, and broadly interpreted, definition of social enterprise. Current CRA policy essentiality shuts the door on the relevancy of social enterprise for registered charities in its Community Economic Development guidance¹⁰. I feel this is an appropriate approach as the social enterprise concept cannot be directly applied to any category without ambiguity and seems to conflict with activity that falls into **Category #1**. The Muttart Foundation also questions the direct linking of social enterprise with charity¹¹.

Focusing the Discussion

There should be two distinct discussions on potential rule changes for business activity. The first one would deal with charities operating an **unrelated or ‘money generating’ business** within their corporate confines (as opposed to a wholly owned subsidiary); the second one would deal with the administration of **fee-based and employment-based charity programs** and whether there is a reason to make changes.

One of the main arguments for allowing **unrelated business activity** is the administrative burden associated with establishing a separate corporate entity can be a hindrance for small charities with little or no staff. I would counter that trying to establish a ‘money generating’ business in the hopes it could provide significant profits on a long-term basis would require establishing an operation that, on its own, most likely exceeds a small charity’s current capacity. This would certainly be the case in the examples of ‘money generating’ businesses – a commercial restaurant, a hotel or a franchise – included in the MaRS report¹².

It is cited in both the MaRS report¹³ and Muttart Foundation submission¹⁴ that other countries do allow charities to operate unlimited business activities so as long the profits are used on charitable activities. One example is a charity in Australia that operates a funeral business that directs its profits to a religious-based charity whose members presumably are the main consumers of the funeral business. In New Zealand, a charity construction operation directs its profits to other charities. In both of these cases, income from the business operations are tax exempt.

It is worth noting that the funeral and construction operations are not considered charitable in and of themselves; they are only allowed to operate within the charity so long as any profits they generate are used for charitable purposes. They are also housed in separate corporate entities and presumably would not use assets from other charities to cover potential liabilities or losses. This is similar to the current rules in Canada that prohibit a charity from providing assets for the operation of a separate for-profit

¹⁰ <https://www.canada.ca/en/revenue-agency/services/charities-giving/charities/policies-guidance/community-economic-development-activities-charitable-registration-014.html> (section F)

¹¹ <https://www.muttart.org/wp-content/uploads/2018/10/Muttart-Submission-Oct.-2018-1.pdf> (page 7)

¹² https://www.marsdd.com/wp-content/uploads/2014/09/MaRS-National_Advisory_Board_Report_EN.pdf (page 15)

¹³ https://www.marsdd.com/wp-content/uploads/2014/09/MaRS-National_Advisory_Board_Report_EN.pdf (page 22)

¹⁴ <https://www.muttart.org/wp-content/uploads/2018/10/Muttart-Submission-Oct.-2018-1.pdf> (page 29)

entity. This means the funeral and construction operations, while in direct competition with for-profits offering the same services in the marketplace, are not getting an unfair and artificial (i.e. subsidized) advantage by use of charity assets.

If Canada introduced this model, a small charity would still have to go through the process of establishing another corporate entity, in this case a registered charity, with a separate board and additional administrative responsibilities.

The other argument for allowing unrelated business activity is income from the business would be exempt from income taxes leaving more for use on charitable programs. I do not have an overly strong opinion on this other than to say it should not be the foundation for allowing unrelated business. Taxes should not be viewed as a penalty for earning profits and charities should expect to pay their fair share for the infrastructure and services provided by government. There is also a bit of a 'robbing Peter to pay Paul' dynamic here as potentially lower tax revenues could lower government funding to the charity sector. The MaRS report seems to share the same mindset.¹⁵

What is not in the Marris report, though, is a clear indication of whether they advocate against using charity assets in the operation of a 'money generating' business (the type they define as "complimentary"). This is based on their recommendation that these would be operated within the corporate confines of a charity while other "business" (presumably something other than a 'money generating' one) could still be run "as a separate taxable subsidiary" that "protect assets from business risk".¹⁶

This appears to be getting into the space where a charity could potentially use 'public' assets to operate an activity that is in direct competition with for-profits who run commercial restaurants, hotels or franchises thus creating the uneven playing ground mentioned in the introduction. The argument put forth by some is that this is acceptable as long as the 'money generating' business is charging the same prices (i.e. market rates) as its competition. What this fails to acknowledge is that the mere presence of a new player in the marketplace is likely to take away business from established players.

Aside from the regulatory element, I am also wary of the strategic application of launching a 'money generating' business. A charity certainly can, in the course of its operations, identify a legitimate business opportunity to explore through a separate business operation but the general feeling I get from the sector is more of an interest in adding to the traditional revenue streams of fundraising and grants with a business activity that has not necessarily been identified organically. There is a sense that one is going to be left behind if it is not jumping on the social enterprise bandwagon and accessing the resources being offered for its development. Strategically, I would caution against committing the significant time, energy, and resources needed to operate an activity that more than likely will offer marginal profits at best while introducing unnecessary financial risks to its 'public' capital.

A discussion about **fee-based and employment-based charity programs** needs to start with much needed clarity regarding the context in which these programs operate before diving into a discussion as to what prospects, if any, there are to intentionally generate profits. This would eliminate defining

¹⁵ https://www.marsdd.com/wp-content/uploads/2014/09/MaRS-National_Advisory_Board_Report_EN.pdf (page 15)

¹⁶ https://www.marsdd.com/wp-content/uploads/2014/09/MaRS-National_Advisory_Board_Report_EN.pdf (page 15)

these activities in narrative as ‘businesses’, and the impression of for-profit business conflict that goes with it, to free up suitable dialogue on possible changes to legislation that is designed to safeguard charitable outcomes.

The notion of altering or eliminating these rules raises a number of questions: Is there an opportunity for greater social impact? Would there be similar concerns of unfair competition with for-profits? And more significantly, would there be concerns of an uneven playing field within the charity sector regarding access to funding and donations?

In reading through a number of publications on this topic including those with a social enterprise theme, I have not found any arguments put forth that challenge philosophically the “cost-defraying” stipulation of a fee-based charity program or the “focusing on helping beneficiaries” stipulation of an employment-themed charity program. Instead, the emphasis seems to be solely on the dynamic of selling of goods and services and the doors it can potentially open to intentional profits through efficiency and business acumen supplemented by funding and donations.

I believe once the underlying philosophy of current CRA policy is better understood, efficiency and business acumen become less relevant, at least in terms of maximizing profits, and questions arise about the application of funding and donations to an activity that generates profits clearly beyond an unintentional level. The question that comes immediately to my mind is: Could those assets be put to better use by another charity without sacrificing overall social impact?

I also believe a better understanding within the sector would allow for more material conversations on moving the sector forward. This would include the promotion of charities, notably private foundations, supporting the work of other charities through Program Related Investments; the opportunity to lower infrastructure and administration costs through strategic partnerships with private and public providers; and, if the ship has not already sailed, a more direct and pragmatic approach to the social finance, social impact bond, and social enterprise concepts by federal and provincial government agencies.