

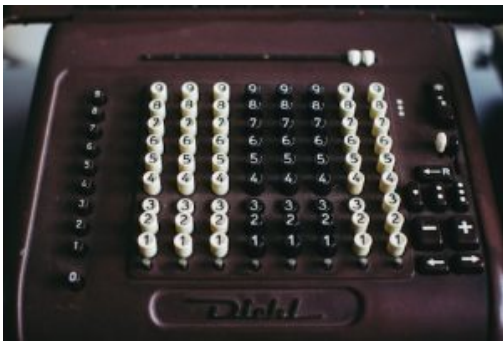
The Business of Charities and Nonprofits: The Need for Change

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Published in *PANL Perspectives*, Carleton University

March 8, 2021

Charities and nonprofits have long been entrepreneurial and innovative in developing new means of generating revenue to achieve their missions and serve our communities. They sell cookies and agricultural products, run cafés, market software, and much more. The devastating effects of COVID-19 on the sector's revenues will press organizations to be even more creative in finding alternative revenue sources. But, current rules make it difficult for Canadian charities – and even more difficult for nonprofits – to engage in 'business' activities (or what some refer to as 'social enterprise'). These restrictions will hinder the sector's ability to recover and rebuild following the pandemic. Reform is urgently needed.



How do you determine what a business is? Photo by Markus Spiske, Unsplash

Charities and Business: What's Related?

Although charities are engaged in a wide array of revenue-generating activities, they do so according to a complex set of rules under the federal Income Tax Act (ITA) and the interpretation of these rules by the Charities Directorate of the Canada Revenue Agency (CRA).

Generally, all of a charity's resources must be devoted to furthering its charitable purposes. Resources used for other purposes, such as a carrying on a business, are subject to strict regulation under the ITA, although it explicitly permits charities to carry on 'related business.' The application of this rule entails first determining what is a 'business,' and then if it is 'related.' As set out in its Policy Statement from 2003 ([CPS-019](#)) CRA considers several factors when determining whether a particular activity is a business activity:

- a profit purpose;
- potential to show a profit;
- a history of profits; and
- whether the people selected to carry out the activity were chosen because of their commercial expertise.

CRA also considers whether for-profits might offer similar programs or services – a position that is not correct in law. Some activities that have a profit-motive, such as fundraisers (assuming they are not continuous activities), sale of donated goods, solicitation of donations and fees (under certain conditions),

are not considered by CRA to be caught by the related business provisions. If you are a fundraiser, you are probably confused by the notion that fundraising should not be an ongoing activity.



Connaught Building, Canada Revenue Agency offices. Photo by Jean Gagnon, Wiki Commons

Limited Clarity

The ITA does not define ‘related,’ and court decisions have been contradictory, leading to substantial confusion. CRA’s current administrative position is that for a business to be considered ‘related,’ it must be *both* linked to a charity’s purpose and subordinate to that purpose, or be run substantially (90%) by volunteers. A business can be linked if it is a usual part of or an offshoot of a charitable program, uses excess capacity, or involves the sale of items that promote the charity. Think of the ‘ladies auxiliary’ running the gift shop at the hospital or the church renting out its parking lot on weekdays.

To determine whether a business is subordinate, CRA will consider several factors, all of which generally relate to whether the business plays a minor role in the charity. Although these rules were intended to be a concession to registered charities, they were introduced at a time when the need for revenue generation was not as acute as it is today, and they are fraught with uncertainty. Noncompliance with the rules comes with harsh consequences, including financial penalties or revocation of a charity’s registration.

Nonprofits and Business: Anything but Profit

A separate – even more restrictive – set of rules and possible consequences apply to nonprofits (those not registered as charities). A nonprofit must operate exclusively for social welfare, civic improvement, pleasure, recreation, or ‘any other purpose except profit.’ The interpretation of ‘any other purpose except profit’ is problematic. CRA has decided to assess this by embarking on an analysis of the operation of the nonprofit, considering whether its board or management are operating with the *intent* to make a surplus or profit. Do its activities have a commercial character? Does it accumulate funds in excess of its nonprofit purposes? Does it budget for a surplus? How long has it run a surplus? Is the nonprofit taking reasonable steps to reduce surpluses, for example, by adjusting the costing of its products or services? In the right circumstances, however, CRA does acknowledge that a nonprofit can earn a surplus without it being stated that it has a profit purpose. Again, the rules are clear as mud.

The error in this approach is arguably that, if a nonprofit’s board allows the organization to operate in a deficit position, the directors could be challenged for not meeting their fiduciary duties. In addition, COVID-19 has acutely demonstrated the need to maintain reserves.



Canada needs a “destination of funds test” for charities involved in businesses. Photo by Toa Heftiba, Unsplash

The Work-Arounds

Usually, a charity or nonprofit does not reach a decision to carry on a business and then ask how to do it. Rather, it recognizes that it has a revenue generating opportunity arising from some aspect of its operations, and asks: how do we take up this opportunity? Out of necessity, they find ways to work around the restrictions.

The solution is normally to create some kind of alternative legal structure. One option is to establish a for-profit corporation to run the unrelated business. The charity’s investment in the corporation must represent a prudent use of its assets, and it must maintain distinct activities and keep separate books and records. The for-profit would be subject to tax, but it could donate up to 75% of its annual income to the charity, avoiding significant tax liability. While there are other possibilities, all of these are costly, time consuming to establish, inefficient, lack transparency and may create confused lines of accountability.

A Better Option

Canada takes a much more restrictive approach to business activities by charities and nonprofits than most other common law countries. It’s time for a less paternalistic approach that would enable the sector to be more financially sustainable and innovative in meeting community needs. The way forward is to adopt the ‘destination of funds test,’ as Australia and New Zealand have done.

The destination of funds test is simple: charities can engage in business activities so long as the profits are put towards charitable ends. The Australian High Court has accepted this test, affirming that what defines

an entity as “charitable” is not whether it raises money by commercial means, but whether the money raised is ultimately put toward a charitable cause or charitable organization. Our argument for a destination of funds test is not new, but has been recommended by [sector leaders](#) for some time, and the [Special Senate Committee on the Charitable Sector](#) recommended a pilot test of this approach.

What is the hurdle to such reform in Canada? The barrier seems to be the notion of an unlevel playing field: that for-profits would be disadvantaged if tax-exempt organizations could carry on business activities. This is a weak case. First, charities and nonprofits are severely restricted in how they raise capital. For-profits are much more capable of pursuing economic activity and generating wealth and are provided with many benefits in the tax system for doing so. Second, there is no evidence that the activity of a charity or NPO creates unfair competition. Generally, a charity/nonprofit wants to generate as much revenue as possible from the activity, which likely means it charges the same fees as others in the market. Finally, most charities and nonprofits operate business-like activities compatible with fulfilling their charitable missions and nonprofit purposes. Their activity should not be directly compared to that of a for-profit.

From a policy perspective, the critical distinction is that a charity or nonprofit generates revenue to further its objective, whereas for-profit entities are structured to generate wealth for owners. When considering how charities and nonprofits can operate and whether business activity can appropriately be pursued, this key distinction should not be forgotten. The tax system insists on taxing the surpluses that will eventually increase the wealth and personal position of others. It does not tax surpluses that are intended to be applied to a purpose other than profit. That policy framework makes sense – if it works. Unfortunately, lawmakers have lost sight of that framework when applying the rules to charities and nonprofits.

While the Minister of National Revenue and CRA have in the past shown little interest in reforming this area of the law, CRA recently began consulting with the Canadian Bar Association and others in the sector to develop new guidance on related business. Our hope is that change is around the corner: that regulators and lawmakers will go beyond clarifying problematic rules to work toward a system that enables the important work of charities and nonprofits.

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This article is a shorter version of a chapter to appear in [Intersections and Innovations: Change for Canada's Voluntary and Nonprofit Sector](#), edited by Susan D. Phillips and Bob Wyatt, to be published online by the Muttart Foundation in 2021.