Maintaining Non-Profit Tax-Exempt Status

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• Introduction
  – Focus of the Paper: Paragraph 149(1)(l) Non-Profit Organization
  – Scope of my discussion
    • Canada Revenue Agency’s (CRA) pre-November 2009 policies versus post and their impact
  – CRA’s Shift in Policy in November 2009
    • Strict Interpretation of the word “Profit”
Definition Includes Must Not Be a Charity

- No tax is payable when the person was:
  - A club, society or association that, in the opinion of the Minister, was not a charity (149.1(1))
  - Objects must not convey a meaning that the objects are charitable - include provision that contradicts the charitable purpose
  - Purpose to serve members and to provide services on a cost recovery basis
Difference Between Charity and 149(1)(l) Entity

• A charity registered with CRA may issue a receipt for gifts received; however, a charity does not have to be registered, in which case it may not issue a tax deductible receipt for donations.

• A paragraph 149(1)(l) entity can not issue tax deductible donation receipts.

• Compliance requirements vary between the two entities; complexity depends on the level of activities they conduct and other factors.
Definition Includes Organized and Operated Exclusively

• That was
  – Organized and
  – Operated exclusively
    • for social welfare, civic improvement, pleasure or recreation or for any other purpose
    • except for profit
  – Profit not defined in the *Income Tax Act*
  – SCC “well accepted business principles, which include but are not limited to the formal codification found in GAAP, are not rules of law but are interpretive aids”

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Importance of Proper Organization

- Make sure purpose is well demonstrated by the objects in the constating documentation
- Can be a proprietorship, partnership, trust, society, Part IX company or corporation
- Company with shares or without shares
- Importance of limited liability protection
- Incorporating under the Business Corporations Act has its own challenges
Definition Also Includes

• No part of the income was payable to, or was otherwise available for the personal benefit of, any proprietor, member or shareholder.

• Income does not include “gift” as defined by CRA: voluntary transfer of property; presence of intention; if advantage received, it is valued and only net amount considered gift.
Definition Also Includes (cont’d)

• Not payable currently or on a winding-up
• If the NPO has powers to pay or the shareholder/member has the right to receive and thus eligible to demand, possible risks:
  – Entity deemed not tax exempt “at the time” and only the winding-up affected
  – However, CRA Compliance Branch may choose to go back; possible reassessment of previous years
CRA’s Pre-2009 View

• Check if entity conducts its activity for profit; and if it does, it is offside the tax-exempt status
• CRA says it is ok to accumulate surplus to provide for capital property to achieve declared exempt activities or meet up to one year of expenses/overhead
• CRA will look at the net after reserve provisions to determine motive for profit
• Condo corporation can earn reasonable interest
CRA New Interpretation

- Can not “intentionally” earn profit to finance future projects
- Condominium corporation can not intentionally collect amounts in excess of what is reasonable; nor may it use these funds to aggressively earn investment income
- Surplus can only arise after sound budget was prepared and resulting excess was unforeseen
Consequences of the Breach of Provision

- Denial of the tax-exempt status, hence income becomes taxable
- Distribution on winding-up taxable to members
- Disposition of member’s interest taxable
- Potential for reassessment of prior years including statute-barred period
- Capital gain which is generally taxable would be taxable
- Sponsorship receipts could be taxable
Consequences of the Breach of Provision (cont’d)

• No surplus would be available to provide cushion for future overhead
• No surplus would be available to pay for new capital acquisitions or replacement of existing capital property
• Uncertainty regarding the existing reserves - how will CRA deal with old surpluses
• If entity relied on reasonable interest income to service debt, that would no longer be available
National Audit in Progress
Prepare Before the Audit

• Tax-Exempt Entity is not tax-exempt if there is evidence of profit motive
• Must file tax and information returns and pay taxes
• If there are reasons to believe that the entity has filed inaccurate returns, use the Voluntary Disclosure Program to amend all previous returns and seek relief from penalties and partial interest
CRA’s Audit May Focus On

• Is it organized to make profit
  – Likely enquiry: Does it have a charter or conducts activity which suggest a motive to make profit; scale of operation; is it run exclusively to make profit, is the profit being used for purposes other than for the non-profit activities, is there sufficient evidence to show the organization’s significant activity focuses on non-profit purposes:
    • Is it making investment to earn income
    • Is it holding large reserve; is that justified
CRA Checks Organizational Aspects

- CRA will examine incorporating documentation to determine:
  - Is it a charity?
  - Objects and purposes
  - Are profits payable to members currently or on winding-up?
  - Are members paid any salaries; are they reasonable?
  - Who will be the recipient of assets on winding up, is it a charity or another similar entity?
CRA Checks Organizational Aspects (cont’d)

• Prepare the case to show the primary purpose of the organization is to provide non-profit activities

• Show the profit is being used for non-profit purposes and no members are benefiting from income payable to them

• Show justification for reasonable salary

• If receiving gifts, show agreements signed between parties
Show Compliance Record

- Required returns under section 150 and provincial legislation have been filed
- Have maintained good bookkeeping and accounting records
- Accounting records match with tax returns
- GST returns if required have been filed
- Information returns have been filed
- Any profits made are used for non-profit purposes
149(1)(I) Changes Raises Planning Issues

• If planning to keep the entity as is, amend articles, by-laws or even enter into shareholder agreements to remove any question about member’s benefit

• Amend provision with regards to distribution on a winding-up to remove any question about member’s benefit

• Avoid dilution of interest of a shareholder or member, it triggers disposition
149(1)(l) Changes Raise Planning Issues (cont’d)

• Incorporate the entity as a Part IX company in Alberta or such other legislation in other provinces, and then amalgamate the entities; this will eliminate member’s benefit issue in the future

• Transfer profit-making activity to a separate corporation - a new subsidiary

• Consider converting the entity into a charity
Closing Comments

• Use of Paragraph 149(1)(l) entity is fraught with danger, and making use of it now is less attractive
• New CRA interpretation will likely drive existing entities to wind-up their operation if they lose their ‘life support’, they need profit to pay for future overheads - cash flow consistency is never guaranteed, and capital property continues to support provision of services to members
• Uncertainty hangs over regarding what CRA would do with existing entities carrying large reserves
Does the Court Agree with CRA?

• “It has long been CRA’s view…”
  – Realization of significant profits, or whether activities are operated in a normal commercial manner, or whether it operates in competition with taxable entities carrying on the same trade or business, or
  – Accumulation of unreasonable reserves, or
  – Whether it is operated on a profit basis rather than a cost recovery basis

“can be evidence of an unstated profit purpose”
Does the Court Agree with CRA? (cont’d)

• “…I agree that, in appropriate cases, these may be reasonable and relevant considerations, though they can not all be requirements, they must be weighed appropriately in the circumstances of each case, and none will be determinative…”

(BBM Canada v. Her Majesty the Queen, 2008 TCC 341)
Jurisprudence May Be Against CRA

• However, questions remain:
  – Do NPOs with limited resources have the capacity to fight CRA?
  – If not, consider what the impact would be
  – Consider what the impact would be on advisors who have provided advice relying on CRA’s previous policy; is this going to lead to litigation against lawyers and accountants?
  – Essentially NPOs will likely ‘surrender’ and wind-up for lack of resources
Jurisprudence May Be Against CRA (cont’d)

• Community members will cease to benefit from low-cost services from such entities

• Let CRA go after the ‘big ones’ that are offside the CRA’s previously published guidelines, but leave most of the small and medium-sized entities alone; give them warnings; work with them; educate them; come up with a clearly defined policy that is reasonable and manageable