



**TAX RULES GOVERNING CHARITIES
AND NON-PROFIT ORGANIZATIONS**

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INTRODUCTION

As of 11 January 2003, there were 79,276 registered charities in Canada, more than double the number that existed when the federal government first introduced the registration process for charitable organizations in 1967.⁽¹⁾ The Canada Customs and Revenue Agency's (CCRA) Charities Directorate received 3,017 applications in 2002 and approved 2,281 of these and earlier applications.⁽²⁾ The number of non-profit organizations⁽³⁾ is not known, although some estimate there may be as many as 100,000 in Canada.⁽⁴⁾

These and other figures indicate an increase in the growth rate of the non-governmental organization (NGO) sector, not just in Canada but worldwide.⁽⁵⁾ Queen's University's School of Policy Studies, for example, cites statistics showing that “[c]itizen organisations worldwide have existed for centuries but it is in the last decade of the twentieth

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- (1) A deduction for charitable donations was first introduced in 1930. From 1930 to 1967, there were no formal requirements for charities to acquire recognition in order to issue tax receipts. See the Canada Customs and Revenue Agency's (CCRA) Registered Charities Newsletter, Spring 2003, available at: <http://www.ccradrc.gc.ca/tax/charities/newsletters-e.html>.
 - (2) *Ibid.* Note that these approvals include a number of applications from years past. Note also that in any given year, the CCRA revokes a number of registrations either at the request of the charitable organization itself or because of an organization's failure to comply with the charitable organization rules.
 - (3) The *Income Tax Act* makes a distinction between charities, which among other things can issue tax receipts, and non-profit organizations, which cannot. This and other differences between these two forms of organization are discussed at length later in the text.
 - (4) See, for example, the homepage of the School of Policy Studies at Queen's University for its research on this subject, available at: <http://policy.queensu.ca/sps/ThirdSector/>. Exact statistics on the number of non-profit organizations are difficult to obtain because, unlike charities, non-profit organizations do not have to register with the CCRA, although they do have to file taxes when their annual revenue or total assets exceed certain thresholds. These and other details are discussed later in the paper.
 - (5) The term “non-governmental organization” (NGO) is used in this paper to describe *all* charitable and non-profit organizations. This term is not universally applied in the relevant literature. Some tend to use the term “non-profit sector,” others the “voluntary sector” and still others use “third sector” to describe what is here referred to as the NGO sector.

century and the beginning of the 2000s that non-governmental ... organisations have flourished.”⁽⁶⁾

There is also evidence that the breadth of NGO activities has grown. The CCRA, which monitors and audits registered charities, notes that modern charities “further a broader range of purposes and activities than ever before as they strive to meet the changing needs of Canadian society.”⁽⁷⁾ While the importance of the NGO sector in terms of its contribution to gross domestic product (GDP) is difficult to quantify, researchers have estimated it accounts for between 4 and 13% of GDP.⁽⁸⁾

Most analysts say the NGO sector has filled a social-policy void left by the federal, provincial, territorial and municipal governments and their spending cutbacks on social programs in the early and mid-1990s.⁽⁹⁾ It has also been argued that the growth in the NGO sector reflects a broader philosophical shift away from federal and provincial government management of the economy towards increasing efforts to strengthen civil society and engage in more public sector–private sector partnerships.⁽¹⁰⁾

The tax system can play an important role in either inhibiting or encouraging the growth of the NGO sector. In “The Tax Treatment of Nongovernmental Organizations: A Survey of Best Practices from Around the World,” the International Centre for Not-for-Profit Law argues that taxation policy has “proven to be a powerful tool for encouraging the constructive development of the NGO sector.”⁽¹¹⁾

(6) See Kathy L. Brock, “Was Seattle Significant: The Emerging Interest in the Third Sector,” Queen’s University School of Policy Studies, available at:
<http://policy.queensu.ca/sps/ThirdSector/Research/index.html>.

(7) See the CCRA’s Registered Charities Newsletter, Spring 2003, available at:
<http://www.cra-adrc.gc.ca/tax/charities/newsletters-e.html>.

(8) A discussion of these estimates, and the research behind them, can be found in an article by Michael Hall and Keith Banting entitled “The Nonprofit Sector in Canada: An Introduction.” It is available through the Queen’s University School of Policy Studies Web site at:
<http://policy.queensu.ca/sps/ThirdSector/Papers/Hall-Banting/TheNonprofitSectorInCanada.html>.

(9) See, for example, a discussion by Arthur Drache, “Developing an Effective Lobby Strategy on Tax Issues for the Voluntary Sector,” 2001, available at:
<http://www.npp.org.za/resources/reports/2001/conference.html>.

(10) This philosophical shift is best embodied in the “third way” approach of politicians such as Prime Minister Tony Blair in the United Kingdom and former president Bill Clinton in the United States. For a discussion of this approach, see Hall and Banting, “The Nonprofit Sector in Canada: An Introduction.”

(11) Available at: <http://www.icnl.org/gendocs/TAXPAPER.htm>.

In Canada, the federal *Income Tax Act* (ITA) contains a number of provisions that encourage charitable giving. It also provides some tax incentives for donations to non-profit organizations. This paper examines these tax provisions, as well as recent changes to the treatment of charities in the ITA, and explores additional changes that could further assist the NGO sector.

DEFINITION OF A NON-GOVERNMENTAL ORGANIZATION

Whether an NGO chooses to organize itself as a non-profit organization or a charity will depend on its objectives. In general, registered charities benefit from a broader array of tax advantages than non-profit organizations, although the latter have certain non-tax advantages not available to charities.⁽¹²⁾ The details of each form of organization are discussed below.

A. The NGO as a Non-profit Organization

Non-profit organizations are “organized and operated exclusively for social welfare, civic improvement, pleasure or recreation or for any other purpose except profit.”⁽¹³⁾ A non-profit organization cannot “distribute or otherwise make available for the personal benefit of a member any of its income,”⁽¹⁴⁾ although it can hire employees, and pay salaries and/or wages as well as reasonable fees and honorariums.⁽¹⁵⁾ Non-profit organizations are generally viewed as targeting a narrower segment of the “public” than charities, a nuance that is made clear in the ITA, which defines a non-profit organization as a “club, society or association that, in the opinion of the Minister, was not a charity.”⁽¹⁶⁾

(12) Both forms of organization are, by definition, “not-for-profit,” meaning they cannot be structured to make profits and distribute those profits to their members.

(13) CCH Canadian, 2000 Edition, *Income Tax Act with Regulations*, Section 149(1)(l).

(14) The one exception to this rule is amateur athletic organizations. See CCRA, Interpretation Bulletin IT-496R, “Non-Profit Organizations,” available at: <http://www.ccradrc.gc.ca/E/pub/tp/it496r/it496r-e.html>.

(15) Non-profit NGOs must apply all applicable taxes (such as employment insurance, Canada Pension Plan premiums, etc.) to their employees.

(16) “A not-for-profit organization may, for example, be primarily a private, not-for-profit social club. This type of club would not normally be eligible to be a charitable organization.” See Donald J. Bourgeois, *The Law of Charitable and Not-for-Profit Organizations*, Canadian Centre for Philanthropy, 2002, p. 3.

As non-profit organizations, NGOs are exempt from paying tax on income from a variety of sources, including donations, interest, dividends or capital gains.⁽¹⁷⁾ Non-profit organizations are also under no obligation to disburse a specified percentage of their income, unlike charities, which have to use at least 80% of their funds on charitable activities or on gifts to qualified donees.⁽¹⁸⁾ Non-profit organizations also do not have to make annual filings with the CCRA if they have less than \$10,000 in annual taxable earnings, or less than \$200,000 worth of assets. Once a non-profit organization exceeds either of these thresholds, it must file Form T1044 and continue to do so in subsequent years. Non-profit organizations are also more able than charities to use their funds for political activities, provided these activities are part of their overall mandate.

The main disadvantage of being a non-profit organization is that donors do not receive any kind of tax benefit, such as the tax credits available for donations to registered charities.

B. The NGO as a Registered Charity

Charities are defined much like non-profit organizations – their activities must be for the public good, and no member can profit financially from these activities.⁽¹⁹⁾ There are two broad classes of charities: charitable organizations and charitable foundations. Charitable foundations can be public or private and are generally set up to disburse funds to charitable organizations, which in turn perform most of the actual program delivery.

A major difference between charities and non-profit organizations is that charitable work is confined to four main purposes, namely the “relief of poverty, the advancement of education, the advancement of religion or other purposes that are beneficial to

(17) They are generally required to pay other taxes such as the Goods and Services Tax (GST), provincial sales taxes (PSTs) and municipal property taxes. Note that non-profit organizations and registered charities with annual sales from fundraising activities (such as tuck shops) of less than \$50,000 are not required to register to collect the GST.

(18) This figure applies only to revenues for which a tax-credit receipt is issued. No such quotas apply to donations for which no receipts are issued.

(19) Charities can be structured either as trusts or as legally incorporated entities. According to Blake Bromley, a tax planning consultant in the area of charity law, the “majority of charities are incorporated as societies or non-share capital corporations.” Bromley made this comment in a presentation to a conference on taxation of the non-profit sector. A transcript of his presentation, and of other aspects of the conference, can be seen at: <http://www.npp.org.za/resources/reports/2001/conference.html>.

the community.”⁽²⁰⁾ All four purposes have expanded in meaning considerably since they were first introduced in England in 1601. The “relief of poverty” purpose, for example, defines poverty much more broadly than in 1601; the “advancement of education” now includes research and development activities; and the “other purposes beneficial to the community” has become a catch-all clause that covers a wide range of activities.⁽²¹⁾ In contrast to non-profit organizations, there is a sense that charities must “benefit the whole community or a significant part of or appreciably important class within the community.”⁽²²⁾ Table 1 shows that religious charities accounted for about 40% of the total number of registered charities in Canada in January 2003, followed by charities dedicated to providing welfare, education and “benefit to community” services.⁽²³⁾

**Table 1: Distribution of Charities by Type
of Charitable Activity in Canada (as of 11 January 2003)**

Charitable Activity	Number of Charities by Activity	Percent of Total
Welfare	15,173	19.14
Health	5,488	6.92
Education	12,896	16.27
Religion	32,161	40.57
Benefit to community	12,186	15.37
Other	1,371	1.73
Total	79,276	100

Source: CCRA, Registered Charities Newsletter No. 15. Available at:
http://www.cca-adrc.gc.ca/E/pub/tg/charitiesnews-15/news15-e.html#P20_4825.

(20) Donald J. Bourgeois, *Charities and Not-for-Profit Fundraising Handbook*, 2000, p. 8.

(21) *Ibid.*

(22) *Ibid.*, p. 9. As Bourgeois goes on to note, “[w]hat is a sufficient or significant part of the community is not always clear.”

(23) However, hospitals, which fall under the “health” category, and teaching institutions, which fall under the “education” category, account for the bulk of charitable revenue, generating 30.4% and 25.9% respectively of total charitable revenue. The majority of these revenues come from federal and provincial government transfers. This is true for most charities. Religious charities are the major exception to this rule, since private donations are their major revenue source. See Hall and Banting, “The Nonprofit Sector in Canada: An Introduction,” for details.

Like their non-profit counterparts, registered charities are exempt from paying tax on income from a variety of sources, including interest, dividends, capital gains, donations and fees.⁽²⁴⁾ Charities also do not have to charge GST on many of the goods and services they provide, and they are entitled to a 50% rebate on some purchases of goods and services.⁽²⁵⁾ Registered charities can issue tax receipts for donations.⁽²⁶⁾ These tax receipts entitle the individual donor to a tax credit worth 16% on the first \$200 worth of donations and 29% on donations above this amount, up to 75% of net income.⁽²⁷⁾ Corporations, on the other hand, can *deduct* (rather than claim as a tax credit) 100% of their charitable donations, up to a maximum of 75% of net income. For individuals and corporations alike, donations can be carried forward for up to five years (i.e., the donor is under no obligation to claim the donation in the tax year in which it was made).

Beginning in 1997, the federal government set the capital gains inclusion rate on donations of publicly traded securities to charities at one-half the inclusion rate for other types of

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- (24) For tax purposes, it makes very little difference whether an NGO's activities are based domestically or abroad. The *Income Tax Act*, for example, allows a Canadian charity to invest in or build projects (such as water pumps, bridges, schools and hospitals) in developing countries and, if the charity so wishes, turn these assets over to the local communities. The Canadian-based charities must, however, have reasonable assurances the assets will not be used to earn a profit by private individuals. Registered charitable status can also be denied to organizations whose foreign activities "run counter to Canadian public policy." For further discussion, see the CCRA's "Registered Charities: Operating Outside Canada," available at: <http://www.ccra-adrc.gc.ca/E/pub/tg/rc4106em/README.html>.
- (25) Charities that are not registered for the GST can claim a 50% rebate on the GST paid on purchases related to their provision of certain exempt goods and services. Charities that are registered generally use the "net tax method" and remit 60% of the GST they collect. The rebate is then calculated on the difference between this amount and any applicable tax credits. As discussed later, the availability of tax credits is the major advantage in registering for the GST (the input tax credits apply only to purchases of goods and services used to provide non-exempt services, i.e., goods and services where the GST *does* apply [or that are zero-rated], such as sales at a tuck shop). Note also that registered charities with gross revenue of \$250,000 or less need not register for the GST (i.e., they are not required to charge GST on fundraising sales).
- (26) To become registered, charities must apply to the CCRA. A charitable organization can choose not to seek this designation (and the tax advantages that go with it) but nevertheless must have a constitution and bylaws.
- (27) This limit may be higher (up to a maximum of 100% of net income) when gifts of capital property (stocks, buildings, etc.) are involved. Note also that when preparing a tax return for a deceased person, the executor may claim *all* eligible gifts given during the year of death plus those bequeathed in the will. The resulting tax credit can be as high as 100% of the deceased's net income for the year. Any remaining amounts can be claimed on the return for the previous year, up to 100% of the deceased's income in that year.

capital gains.⁽²⁸⁾ A similar measure was introduced for donations of ecologically sensitive land in the 2000 budget. In 2001 and beyond, donors have to include 25% of any capital gains resulting from the donation of publicly traded securities or ecologically sensitive land to a charity,⁽²⁹⁾ rather than the 50% rate that would have applied had the measures not been implemented.⁽³⁰⁾ These measures were made permanent in 2001.

The major disadvantage to becoming a registered charity is the legal expenses incurred by the act of incorporation, as well as the requirement to make annual filings with the CCRA and restrictions on political activities (discussed in greater detail later in the text).

ASSISTING NON-GOVERNMENTAL ORGANIZATIONS THROUGH THE TAX SYSTEM

As the foregoing analysis indicates, the *Income Tax Act* includes a number of provisions to assist non-profit organizations and registered charities. Mechanisms for enhancing these tax advantages are discussed below.

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- (28) Special rules also exist for donations of cultural property to Canadian institutions and public authorities. For example, the donor does not pay any tax on capital gains resulting from a gift of this kind, nor are there any limitations on the size of the resulting tax credit vis-à-vis net income.
- (29) The capital gain (or loss) for donations of publicly traded securities is calculated by comparing the “adjusted cost base” (essentially the cost of the asset) with the (fair) market value at the time the donation is made. Note also that the ITA allows a donor to specify (“designate”) the market value so long as this designated amount is less than the fair market value but more than the adjusted cost base. The capital gain calculation for ecologically sensitive land is somewhat more complex. Here, the amount of the gift is the greater of the market value of the land or the amount of the reduction in the land’s market value as a result of making the gift. Claims on this kind of gift are not limited to a percentage of the donor’s net income.
- (30) A 2000 Deloitte & Touche survey of 471 Canadian charities found that the average gift of publicly traded securities in 1999 was \$251,626, almost 20 times the average donation of \$13,022 in 1996, the year before the lower inclusion rate was introduced. See Deloitte & Touche, “Survey of Gifts of Publicly Listed Securities,” available at: http://www.afptoronto.org/resources/deloitte_touche_report.html. In 2002, the Department of Finance released a study that found, among other things, that the growth in gifts of publicly traded securities to registered charities was much faster than the growth in total donations between 1997 and 2000. See Department of Finance, “Special Federal Tax Assistance for Charitable Donations of Publicly Traded Securities,” available at: http://www.fin.gc.ca/taxexp/2002/taxexp02_5e.html. Note, however, that an increase in donations of Publicly Traded Securities is not the same thing as an increase in overall charitable giving. Some tax specialists have argued that the lower inclusion rate only encouraged a substitution of publicly traded securities for cash. For a detailed critique of the lower capital gains inclusion rate on donations of publicly and traded securities, see: “Thinking Critically About Taxation of Capital Gains on Donated Public Securities (or Looking Paragraph 38(9.1) in the Mouth” by Lisa Philipps, and “Special Federal Tax Assistance for Charitable Donations of Publicly Traded Securities: A Tax Expenditure Analysis,” by David Duff. Both articles appear in Volume 51, n^o 2 (2003) of *The Canadian Tax Journal*, pp. 913-925.

A. RRSP-like Tax Shelters

Registered Retirement Savings Plans (RRSPs) were introduced in 1957 as a means of encouraging citizens to save for retirement. Funds invested in an RRSP are tax-deductible, reducing the amount of income subject to tax. Capital gains, interest and dividends earned on an investment held in an RRSP are not taxed until funds are removed from the plan. One way to increase charitable giving might be to create a separate, RRSP-like savings plan for NGO donations (henceforth, an NGO savings plan). This would presumably entail some mechanism to allow individuals to transfer tax-sheltered funds to the charity or non-profit organization without being taxed.⁽³¹⁾

While the proposal for an NGO savings plan may appeal to some, it would likely encounter several objections. First, it might be argued that efforts to extend RRSP-like provisions to other areas not related to retirement (in this case, NGOs) could lead to additional proposals for RRSP-like provisions, which if accepted could undermine the federal government's tax base.⁽³²⁾ This could also undermine the rationale behind RRSPs, which, as the name suggests, are meant to encourage people to save for retirement.⁽³³⁾

Second, an NGO savings plan could divert savings from RRSPs and other retirement savings plans (what economists call the substitution effect).⁽³⁴⁾ If this happened to a significant extent, it could undermine Canadians' ability to pay for their retirement. There is, for example, limited empirical evidence that RRSPs actually increase overall savings.⁽³⁵⁾

(31) Without such a mechanism, any funds held in the NGO savings plan would be taxed as soon as they were removed to make the donation, much as they are with RRSPs. While the tax consequences would be offset to varying degrees by the charitable tax credit, the idea behind an NGO savings plan is presumably to *increase* the incentives for charitable giving.

(32) This is a "slippery slope" type of argument. It says that once an exception is made to a rule (in this case, the rule that RRSP-type structures are meant only for retirement purposes), it becomes very difficult to deny other proposals or exceptions. In other words, the "rational" basis for rejecting these other proposals is weakened.

(33) A possible rebuttal to this objection might be to point out that Registered Education Savings Plans (RESPs) and the Home Buyers' Plan also violate the notion of saving for retirement.

(34) With RRSP investments there is also a "wealth effect" that comes from the fact that income in RRSP-sheltered investments is not taxed and, therefore, the RRSP-owner is wealthier than he or she would otherwise be. This may induce him or her to save less than if the RRSP plan did not exist. This "wealth effect" would not apply in the case of an NGO savings plan since, by definition, the funds for this plan would be destined for the NGO and therefore would not be controlled by the individual in any way.

(35) As Barbara Austin has noted, even at the theoretical level "the effect of tax incentives on retirement saving is uncertain." See Barbara Austin, "Policies, Preferences and Perversions in the Tax-Assisted Retirement Savings Plan," *McGill Law Journal*, Vol. 41, 1996, p. 581.

Third, some might object to the proposal for reasons of equity. Most Canadians do not make full use of their RRSP contribution room.⁽³⁶⁾ This is especially true for low-income persons. Statistics Canada data show, for example, that between 1993 and 1999, “28% of all taxfilers aged 25 to 64 did not save through RRSPs or RPPs; most of these non-savers (83%) had incomes of less than \$20,000.”⁽³⁷⁾ These data also show that “income remains the most important factor in predicting whether an individual will save for retirement. Nearly 80% of taxfilers with income of \$30,000 to \$39,999, and virtually everyone (95%) in higher income groups, saved regularly or consistently for retirement (through [a Registered Pension Plan] or RRSP between 1993 and 1999).”⁽³⁸⁾ The reason behind this empirical fact is clear: high-income, employed individuals have both the means (high income and/or a job that offers an RPP) and incentive to save in an RRSP/RPP because they are taxed at higher marginal rates than their lower-income counterparts. An NGO savings plan would, therefore, largely benefit high-income earners.

Fourth, and in related fashion, there is nothing to prevent individuals from using the current system to allocate some portion of their existing RRSP to charities or non-profit organizations. Under current tax rules, an individual could “cash out” a portion of his or her RRSP income if he or she wished to donate some of these RRSP funds to an NGO. This would yield a tax credit for the amount of the donation, which could offset any taxes owing as a result of the withdrawal.⁽³⁹⁾ Rather than creating an NGO savings plan, it might be better to create tax rules that would allow individuals to transfer some of their RRSP investments to an NGO without being taxed at all (while still allowing full use of the charitable tax credit). Such a measure is currently being considered in the United States for individual retirement account (IRA) tax shelters, which are similar to Canada’s RRSPs.⁽⁴⁰⁾

(36) In 1999, for example, “[m]ost Canadians (59%) did not use any of their RRSP room”; see Statistics Canada, *Retirement Savings Through RPPs and RRSPs*, Statistics Canada Catalogue No. 74F0002XIB, June 2001, p. 11.

(37) *Ibid.*, p. 10.

(38) *Ibid.*

(39) For those in the highest tax bracket, the monies withdrawn would be taxed at a 29% rate. Assuming the charitable donation was worth more than \$200, this would be largely offset by the resulting 29% tax credit.

(40) For a discussion of this proposed measure, see, for example, the following page on the Web site of the Independent Sector, a lobby group representing U.S. charities and non-profit organizations:
<http://www.independentsector.org/programs/gr/IRARollover.html>.

Finally, it might be argued that there are other, more efficient and direct ways of assisting NGOs. For example, treating NGO donations as tax deductions rather than tax credits would achieve results similar to an NGO savings plan – individuals would receive an immediate deduction for all donations, while the NGO would not be liable for any interest or dividends accruing on these investments. These other possible tax measures are discussed below.

B. Donations as Tax Deductions Versus Tax Credits

Until 1988, the ITA allowed citizens to claim their charitable donations as deductions rather than as tax credits. The shift towards tax credits was justified on the grounds of equity: deductions reduce the amount of income subject to tax and, all other things being equal, yield a greater benefit for high-income individuals facing higher marginal tax rates because of Canada's progressive tax system.⁽⁴¹⁾ A tax credit system treats everyone equally because tax credits affect tax payable, not the amount of income subject to tax: high- and low-income donors receive the same 16% tax credit on the first \$200 of donations and the same 29% tax credit on donations above this amount.

Statistical analysis using Statistics Canada's policy simulation model, however, reveals that the current tax treatment of charitable donations as tax credits can be *more* generous than a tax deduction for all but the highest-income taxpayers. For those in the lowest tax bracket who face a 16% marginal tax rate, the tax credit system is more generous for *any* donation worth more than \$200.⁽⁴²⁾ For those in the two middle tax brackets (i.e., facing the 22% and 26% marginal tax rates), the tax credit system is preferable (and therefore more costly for the federal government) for any donation above \$371.43 and \$866.67 respectively. For those in the highest

(41) To illustrate how tax deductions *normally* favour higher-income individuals, consider two citizens. Citizen A had annual income of less than \$31,677 in 2002 and therefore faced the lowest marginal tax rate of 16%. Citizen B had annual income of more than \$31,677 (but less than \$63,354) and therefore faced a marginal tax rate of 16% on the first \$31,677 of taxable income and a marginal tax rate of 22% on the next \$31,677 of taxable income. Suppose they both donated \$100 to a charity. Under the current tax credit system, the donation would yield the same tax benefit for both taxpayers: both would have their tax payable reduced by \$16. Now imagine that the tax system allowed a tax deduction rather than the current system of tax credits. While this would reduce Citizen A's and Citizen B's taxable income by \$100, the ultimate effect for each person is different. Citizen A's \$100 donation "costs" \$84 (because Citizen A would have, in the absence of a deduction, paid \$16 of tax on the \$100 donation) compared with \$78 for Citizen B (who would have paid \$22 of tax in the absence of a deduction).

(42) These figures were obtained by applying a formula that calculates the point where a taxpayer would be indifferent, all other things being equal, between the current system of tax credits and a system of tax deductions. Mathematically, this can be expressed as: $my - (32 + 0.29(d-200)) = (y - d)m$, where m = marginal tax rate; y = gross income; d = donation. Solving for "d" yields the figures cited in the text.

tax bracket (i.e., facing a 29% marginal tax rate), the deduction is preferable to the current tax credit structure in all circumstances.

The move to a system of charitable tax credits was not without controversy, primarily because there is some evidence that “high income taxpayers are quite sensitive to tax rates and that allowing deductions rather than credits tends to attract more and larger gifts from wealthy donors.”⁽⁴³⁾ To the extent this is true, treating charitable donations as tax deductions rather than tax credits could encourage more giving, particularly among high-income earners. Furthermore, once a donation is given to a charity or non-profit organization, it (as well as any revenues it might earn) cannot be taxed.

The main drawback to allowing tax deductions (instead of tax credits) for charitable donations is that it might prove less generous for anyone but high-income earners. It might also encourage other proposals to convert tax credits into deductions, which could ultimately undermine the federal government’s tax base.

C. Increasing Tax Credit Limits

As discussed earlier, the *Income Tax Act* imposes limits on the amount an individual can claim as a tax credit in a given year. Currently, the limit is 75% of net income, with some exceptions for donations of publicly traded securities, ecologically sensitive land and cultural items. Increasing this 75% limit might encourage high-income earners to donate greater amounts.

D. Allowing for Greater Economic Activity

Charities, and by extension NGOs, might also be assisted through tax changes that would allow them to earn a greater share of their revenue from “economic activities,” activities that involve the production of goods or services for sale to the public. There are three ways of addressing this issue:

- i. *Destination of income test*: exempt from taxation all profits earned from economic activity provided the NGO has filed the proper paperwork to qualify as a registered charity and has committed to using all or some percentage of its profits for charitable or public

(43) The International Center for Not-for-Profit Law (ICNL), “The Tax Treatment of Nongovernmental Organizations: A Survey of Best Practices from Around the World.”

ends. While Canadian tax law already allows some business activity,⁽⁴⁴⁾ the ITA could be changed to allow a greater amount and wider variety of economic activity.

- ii. *Principal purpose test*: exempt from taxation all profits from “related activities” only. Related activities might include, for example, the publication of a magazine devoted to the NGO’s area of concern (for example, the promotion of certain kinds of art or culture). Canadian tax law could be studied to identify any further opportunities for this kind of tax assistance.
- iii. *Mechanical test*: exempt from taxation amounts determined by a mechanical, straightforward formula. For example, the law could be changed to allow NGOs to earn a certain percentage of their total income from economic activities. In Hungary, for instance, NGOs are exempt from tax on the net profits from economic activities if the annual unrelated business income does not exceed the lesser of 10 million forint (equivalent to about CAN\$66,000 at the time of writing) or 10% of total revenue.

There are three main drawbacks to all three tests.⁽⁴⁵⁾ First, broadening any of the existing constraints on business activities could undermine the rationale for charitable and non-profit organizations, which is to provide “public benefits,” not to make profits. Second, any effort to broaden the existing constraints could lead to unfair competition with private-sector for-profit firms that do not benefit from the tax provisions available to registered charities. Third, broadening the allowable activity could lead to risky ventures that put the charity itself at risk. At a minimum, any effort to broaden the existing rules governing allowable business activities should perhaps involve a review of case law.

(44) Under current rules, the charity’s business activity “cannot become a substantial commercial endeavour. If the business activity is not a substantial commercial endeavour, it will be considered to be a ‘related business’ activity where it meets the following four factors: (1) The activity is related to the charity’s objects or ancillary to them; (2) There is no private profit motive, since any net revenue will be used for charitable activities; (3) The business operation does not compete directly with other for-profit businesses; (4) The business has been in operation for some time and is accepted by the community.” The Hutterian Brethren, for example, were denied charitable status for their farming activities because while “the motivation of the individuals may have been for religious purposes, ... the corporate entity carried out those activities for business purposes.” See Bourgeois (2002), pp. 33-34.

(45) These three drawbacks have all been recognized, in one form or another, by the CCRA, the courts and regulators. See Bourgeois (2002), p. 32.

E. Extending GST Provisions

As noted earlier, NGOs as charities are currently entitled to a 50% rebate on the GST paid on goods and services related to certain “exempt activities.” While this rebate could be increased to 100%, a higher rebate could put pressure on the federal government to extend the measure to public institutions (such as municipalities) that are also subject to the 50% rule. Alternatively, the federal government could reclassify a number of “exempt” activities as “zero-rated” activities so that charities would be eligible for all related tax credits.⁽⁴⁶⁾

F. Preferential Treatment or Exemption From Customs Duties on Imported Goods and Services

Canadian tax law could be modified to exempt NGOs from paying customs duties on imported goods and services. This could be especially important for humanitarian agencies that work in disaster situations and have to import most of their goods and services. It is less likely to be an issue in developed countries such as Canada, where substantial infrastructure and emergency preparedness already exist. Also, there is at least one major problem with this approach: it may encourage illicit activity (i.e., “NGOs” may be set up as fronts for illegal import operations).

G. The House of Commons Standing Committee on Finance Recommendations

In its 2002 pre-Budget consultation report *Canada: People, Places and Priorities*, the House of Commons Standing Committee on Finance made three recommendations designed to assist the charitable and volunteer sectors in their efforts to raise funds. The Committee recommended that:

1. *The federal government amend the Income Tax Act to eliminate the capital gains inclusion rate applied to donations of publicly traded securities to charitable organizations, including private foundations.*⁽⁴⁷⁾

(46) See footnote 25 for a discussion of the rules on the GST tax rebate.

(47) Donations of publicly traded securities or ecologically sensitive land to private foundations are currently ineligible for the reduced capital gains inclusion rate available for donations to registered (public) charities.

The rationale behind this recommendation was twofold. First, there is some evidence that the initial reduction in the capital gains inclusion rate to 25% of capital gains in 1997 encouraged increased donations of publicly traded securities to charities.⁽⁴⁸⁾ Eliminating the inclusion rate altogether could encourage further contributions to the charitable sector, although the ITA already allows donors to structure their donations of securities in such a way that they pay virtually no capital gains tax.⁽⁴⁹⁾ Second, private foundations were excluded from the lower inclusion rate introduced in 1997.⁽⁵⁰⁾ Extending the provision to them could also increase donations of publicly traded securities.

2. *The federal government study the feasibility of extending the provisions regarding the capital gains inclusion rate applied to donations of publicly traded securities to donations of real estate and of land. This study should be undertaken with a view to phasing in the application of the change when feasible.*

This recommendation is directed towards increasing donations of land to environmental trusts interested in creating more green space in downtown urban areas. Currently, the lower capital gains inclusion rate applies only to ecologically sensitive lands.

3. *The federal government encourage active dialogue between relevant departments and the voluntary sector regarding how the sector might best participate in the policy-making process without risking their charitable status.*

In recent years, a number of charities have complained that the ITA rules on political activity are too restrictive. Under the current rules, registered charities are allowed to engage in political activity only to the extent that such actions are considered “ancillary and incidental” to their

(48) See footnote 30. The evidence is “circumstantial” because it is difficult to know whether the increase in donations was due to changes in the tax law or Canada’s strong economic performance and rising stock markets. Also, as discussed in footnote 30, some have argued that the lower inclusion rate merely led to a substitution of publicly and trade securities for cash, and not to an overall increase in donations.

(49) Recall that donors can “designate” the fair market value of the publicly traded securities as long as this designated amount is more than the adjusted cost base and less than the fair market value. See the discussion on “designation” in footnote 29.

(50) Private foundations generally are dependent on a small number of donors. Technically, they are defined as foundations where more than 50% of the foundation’s capital comes from a single individual or group of related individuals (i.e., a wealthy individual or family). Private foundations also generally have much less diverse and less arms-length boards of directors, i.e., they are often composed of people closely aligned with the donor.

main charitable work.⁽⁵¹⁾ In practice, this means that a charity “that meets its disbursement quota (by spending at least 80 percent of its receipted donations of the previous year on charitable activities) and in doing so spends no more than 10 per cent on permitted political activities” would be operating within the rules.⁽⁵²⁾

The question of what constitutes a political activity is somewhat ambiguous. As the CCRA’s Information Circular on the subject notes, “[w]hether a particular activity is fundamentally charitable or fundamentally political depends on the facts of the particular situation; it is a matter of degree that must be judged on a case-by-case basis.”⁽⁵³⁾ Oral or written presentations to a Member of Parliament, government bodies or the media, for example, are seen as falling “within the general ambit of charitable activities as long as the devotion of resources to such activity is reasonable in the circumstances (i.e., is intended to inform and educate by providing information and views designed primarily to allow full and reasoned consideration of an issue rather than to influence public opinion or generate controversy).”⁽⁵⁴⁾

Political activities that count towards the 10% limit include publications, conferences, workshops, advertisements, public meetings, organized demonstrations and mail campaigns or any other activity designed to sway opinion on political issues and matters of public policy. “Partisan” political activities, such as the endorsement of one electoral candidate over another, are prohibited to charities.

CONCLUSION

The NGO sector has grown in recent years, due in part to reduced federal, provincial, territorial and municipal government delivery of social services and changing philosophies about the role of government. The tax system can impede or encourage this growth. As discussed above, the *Income Tax Act* contains a number of provisions to encourage

(51) Details can be found in the CCRA’s Information Circular IC87-1, “Registered Charities – Ancillary/Incidental Political Activities,” available at: <http://www.cra-adrc.gc.ca/E/pub/tp/ic87-1/ic87-1-e.html>.

(52) A second, “operational” test requires that when a charitable organization engages in political activities, “substantially all” (i.e., 90%) of its resources – including staff resources and all funds (not just those for which receipts were issued) – must be devoted to its charitable activities. See the CCRA’s Information Circular IC87-1, paragraphs 13 and 15, for details.

(53) *Ibid.*

(54) *Ibid.*

giving and to assist the NGO sector as registered charities or non-profit organizations. Tax-based mechanisms for further assisting NGOs could also be developed, however. These could include amending the existing RRSP program to allow individuals to transfer some of their RRSP savings to charities tax-free, changing the charitable donations tax credit into a deduction, increasing the maximum annual tax credit for charitable donations, allowing NGOs greater scope for economic activity, extending GST provisions, setting the capital gains inclusion rate on donations of publicly traded securities and other assets to zero, extending the lower inclusion rate for donations of publicly traded securities to private foundations, and providing NGOs as charities with more latitude to engage in political activities.

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