

Toward a More Modern and Systematic Approach to Tax Treatment of Non-Profit Organizations Engaging in Public Policy Development in Canada: Moving Beyond Cinderella's Slippers

Draft, February, 2003

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Paper to be presented at February, 2003 Carleton School of Public Policy and Administration Luncheon Speakers Series on Voluntary Sector

This paper represents the author's personal opinion and not that of any organization he might be affiliated with, nor of any other persons with which the author has collaborated in the past. The paper draws substantially on: K. Webb, *Cinderella's Slippers: The Role of Charitable Tax Status in Financing Canadian Interest Groups* (Vancouver: UBC-SFU Centre for the Study of Government and Business, 2000); P. Pross and K. Webb, "Embedded Regulation: Advocacy and the Federal Regulation of Public Interest Groups" (paper presented at Queen's University Third Sector Conference, October, 2001); P. Pross and K. Webb, "Will the Walls Come Tumbling Down? The Possible Consequences of Liberalizing Advocacy Constraints on Charities" (paper presented at Queen's University Third Sector Conference, October, 2002); and P. Finkle, K. Webb, W. Stanbury and P. Pross, *Federal Government Relations with Interest Groups: A Reconsideration* (Ottawa: Consumer and Corporate Affairs Canada, 1994).

Introduction

Current ***Income Tax Act*** treatment of non-profit organizations engaged in public policy activities is haphazard and inequitable, the product of a gradual, historical accretion of legislative changes, judicial pronouncements, and administrative interpretations. No attempt has been made in Canada to articulate an overarching, systematic, principles-based vision concerning the tax treatment of non-profit organizations engaging in public policy development, and in turn no attempt has been made to re-organize existing categories in support of the vision. In the absence of such a vision and attendant re-organization of the existing categories, the ***Income Tax Act*** continues to send out mixed signals to non-profits (and indeed, to greater society) about public policy activities of such groups, discouraging some and encouraging others in an almost random manner. Several current reform efforts which attempt to address issues in a piecemeal fashion risk falling into the scenario of solving one problem while creating another.¹

Non-profit organizations are currently treated under Part I of the ***Income Tax Act*** in a number of different ways:

- ∃ ***the “non-profit organization” Income Tax Act category*** -- this category includes, without distinction, both pleasure or recreation-oriented clubs and those with a focus on social welfare and civic improvement. Non-profits in this category can engage in any advocacy activity they wish, and are not subject to taxation under Part I of the ***Income Tax Act***. However, they cannot issue tax receipts for donations which are tax deductible to those who provide donations;
- ∃ ***the registered charity category*** -- non-profit organizations which are concerned with the advancement of education, relief of poverty, advancement of religion, and other purposes beneficial to the community (as defined by the courts) may fall into the “registered charities” category, and if approved as such by the Canada Customs and Revenue Agency (CCRA), these organizations can provide tax credit or deduction receipts to those who provide donations. However, there is a bias in favour of service-oriented organizations, and public policy activity of charities is subject to considerable restrictions. Research suggests that many charities are reluctant to engage in advocacy activity for fear of running afoul of the restrictions on advocacy activities, and thereby losing their charitable status;
- ∃ ***the registered arts promotion and amateur athletics promotion organizations*** -- non-profit organizations which are concerned with promotion of the arts or amateur athletics have been granted their own special registered tax status, and as such can provide tax credit or deduction receipts to those who provide donations. However, advocacy activity of such organizations is subject to basically the same restrictions applying to registered

¹ Discussed in greater detail below.

charities;

- ∃ ***deductible commercial lobbying*** -- businesses can fully deduct membership fees and other expenses paid to industry associations (a form of non-profit organization), and these industry associations are not subject to any restrictions on general advocacy activity under the ***Income Tax Act***, although lobbyists are subject to the ***Lobbyists Registration Act***.

As is probably apparent from this description of the available categories, non-commercial public interest non-profit organizations wishing to engage in public policy development activities are currently subject to a very uneven and arguably, inequitable playing field of tax treatment under the ***Income Tax Act***. Consider the following examples of such uneven and inequitable treatment:

- ∃ anti-abortion groups have lost their charitable tax status while abortion rights groups have maintained theirs;
- ∃ immigrant groups assisting new Canadians to integrate into society have been refused charitable tax status, while aboriginal groups doing similar activity have been accepted as registered charities;
- ∃ anti-pornography groups have had their applications for charitable tax status rejected while anti-smoking groups have been accepted;
- ∃ think tanks critical of government policy have been accepted for tax status while environmental organizations critical of government policy have been rejected;²
- ∃ industry associations and other commercially oriented non-profit organizations, financed by contributions from businesses which are tax deductible, are able to engage in advocacy activity pertaining to, e.g., environmental, health and safety, tax policy, or any other public policy matter, without any restriction under the ***Income Tax Act***.

For many public interest non-profit organizations, the registered charity tax status represents the most attractive category available, given the potential to attract tax deductible donations, even though advocacy activity undertaken pursuant to the registered charity category is limited.

Elsewhere, I have suggested that the current rules lead to pressure for public interest oriented non-profit organizations to mis-describe their objectives, under-report their advocacy activities, or suppress their advocacy activity, so as to qualify for or maintain charitable tax status. I've described this as the "Cinderella's Slippers" phenomenon. In the story of Cinderella, it will be recalled that only Cinderella's feet would fit into the slender glass slippers, much to the dismay of Cinderella's larger-footed sisters, who tried unsuccessfully to force their feet into the delicate form. The sisters were desperate to fit into the slippers, since the woman who did would

² These are all discussed at pp. 9 - 11 of K. Webb, ***Cinderella's Slippers? The Role of Charitable Tax Status in Financing Interest Groups*** (Vancouver: SFU-UBC Centre for the Study of Government and Business, 2000).

become the prince's wife, showered with wealth and adulation. Leaving aside the political incorrectness of the story in today's climate, the main point of relevance to this analysis of tax treatment of non-profit organizations is the exclusive benefits flowing to the woman whose feet fit the slippers, and the image of others teetering around in the slippers, claiming that their feet fit when they did not.

Is it a force-fit to include public policy-oriented organizations with no service activities under the charity category? Must there be effectively only a single category of organization which receives the benefits associated with being able to issue tax receipts or for donations which are tax deductible,³ or could there not be several carefully tailored categories available, designed to address the variety of organizations in operation? If more than one type of organization attracted its own special tax status, would this not decrease the pressure on all organizations to attempt to fit into the single category, and the need to apply seemingly ambiguous and arbitrary distinctions between acceptable and unacceptable charity activity? These sorts of questions underlie the suggestion made here for a new category of registered interest organizations (RIOs), and attendant changes to the non-profit organization and registered charities categories.

If one starts from the premise that free and open public policy debate is a fundamental principle of democracy, and that non-profit organizations can valuably participate in this debate, then it is difficult to justify the current uneven treatment of public policy activities of non-profit organizations under the *Income Tax Act*. Why should certain groups be subject to considerably more restraints than others? Why should some have the ability to attract tax deductible donations while others do not? This is not to suggest that all non-profit organizations should be treated the same, but rather that the current uneven approach to tax treatment does not recognize the differences among organizations, and respond in a consistent and systematic way. As a result it is not facially justifiable in terms of encouraging free and open public policy debate.

There are currently efforts underway to liberalize the rules pertaining to advocacy activities of charities.⁴ Such efforts are laudable, but do not address the presently operating

³ For purposes of discussion here, the author is including Registered National Arts Service Organizations and Registered Canadian Amateur Athletic Organizations as specialized forms of the registered charities category.

⁴ Institute for Media, Policy and Civil Society (IMPACS) and the Canadian Centre for Philanthropy (CCP), *Let Charities Speak: Report of the Charities and Advocacy Dialogue* (Vancouver, B.C.: March, 2002) According to the report (p. 9), direction for the project from the national dialogue can be summarized as: advancing a clarification of prohibited activities and increasing non-partisan advocacy by charities to allow up to 100% advocacy or the creation of an up to 49% rule; initiating the development of an advocacy code of ethics, pursuing a process with government to create a new legislated definition of "charity" (as opposed to the current

arbitrary distinction between groups which can obtain charitable status and which cannot, nor do such efforts recognize the distinction between service and non-service-oriented public policy organizations, or the current jumbling together of pleasure or recreation-oriented clubs with those concerned with civic improvement and social welfare.

Today I will make a preliminary attempt to sketch an outline of one possibly more coherent, consistent systematic vision and approach for *Income Tax Act* treatment of non-profit organizations involved in public policy debates, revolving around creation of the proposed new Registered Interest Organization category.

The Current Non-Profit Organization Category under the Income Tax Act

Like charities, non-profit organizations are exempt from paying income tax under Part I of the *Income Tax Act* (indeed, charities can be described as a specialized form of non-profit organization). However, charities can provide receipts to donors who, if they are individuals, are entitled to claim a tax credit for their donations, and if corporations, may claim a deduction from their taxable income for donations. The ability of charities to provide tax credit or deduction receipts creates a distinct inducement for individuals and corporations to give to charities which other non-profit organizations do not possess.

Compared with the requirements pertaining to registered charities, the rules under the *Income Tax Act* pertaining to non-profit organizations are minimal. Unlike a charity, a non-profit organization does not have to first register either federally or provincially to maintain its non-profit tax status. Instead, non-profit organizations generally file returns only if they earn more than a certain amount of income per annum ((\$10,000) or have more than a certain amount of assets (\$200,000), or if the organization takes the form of a corporation. The Revenue Canada return form for non-profit organizations contains modest obligations, requiring only that basic information be provided to correctly identify the organization, its type (see below), the amounts received, the assets, liabilities, and remuneration paid to all employees and officers, a brief description of the organization's activities and location of those activities, as well as the location of the organization's books and records.

To be an organization exempt from paying taxable income, a "club, society or association" must:

- not be a charity;
- "be organized exclusively for social welfare, civic improvement, pleasure, recreation or any other purposes except profit";

common law-based definition); supporting the creation of a Canadian Charity Commission or some other form of monitoring of the administration of charities, and making a formal request of the Auditor General of Canada to conduct a "fairness audit" of the Charities Directorate of the CCRA.

- in fact operate exclusively for the same purpose for which it was organized; and
- not distribute or otherwise make available for the personal benefit of a member any of its income unless the member is a registered Canadian amateur athletic organization.

It should be apparent that the scope of what constitutes a non-profit organization as defined here is much broader than simply public interest groups, potentially encompassing clubs or associations organized for pleasure or recreation (i.e., it includes self-interested, private, non-commercially oriented non-profit organizations). The group is essentially a grab-bag of “not charities,” with no distinction or preference given for those with a public interest, social welfare or civic improvement orientation, as opposed to those with a self-interested pleasure or recreation focus. There are no explicit rules pertaining to non-profit organizations’ political or policy advocacy activity contained in the *Income Tax Act* or CCRA interpretation bulletins and other guidelines and documents. Insofar as the category encompasses clubs and associations organized for pleasure or recreation, it is apparent that rules pertaining to political or policy advocacy activities would in most circumstances serve no purpose, and indeed would be largely irrelevant. The same could not be said, however, for those groups which have a civic improvement or social welfare orientation.

The Registered Interest Organization Option

An option which was noted but not seriously pursued by IMPACS/CCP in their consultations, and which extends beyond reform of the advocacy rules associated with charities, is the creation of a new category of organization called “registered interest organizations” or RIOs, which would be exempt from taxation, be registered, have an unrestricted ability to engage in political activities, and be able to issue tax receipts (although the level of deduction would be different and likely lower than that available to groups with charitable status).⁵

The proposed RIO category⁶ would be a carve-out from the current non-profit organization category, distinct in that it consists only of non-profit groups with a non-

⁵ This option was developed in greater detail in K. Webb, *Cinderella’s Slippers?, op cit.*

⁶ In a survey of 20 non-profit and charitable organizations undertaken in 2000-2001 by Pross and Webb, six of the respondents wanted a new tax status for groups engaging primarily in advocacy activities. Another two wanted more information concerning this option. See Pross and Webb, “Embedded Regulation: Advocacy and the Federal Regulation of Public Interest Groups” (paper presented at Queen’s University Third Sector Conference, October, 2001). One respondent suggested that the separate status “could be supported as a different class of organization. It would recognize that there is a certain public interest in ensuring that these groups exist.” Another agreed, but said there should still be some restrictions. Five respondents said they agreed with the current restrictions but indicated that the rules needed clarifying. It should be noted that 14 of the 20 survey respondents were registered charities.

commercial, public policy development orientation (thus eliminating self-interested clubs, pleasure or recreation groups and business groups), requires registration, and would require compliance with a RIO code of accountability which would make transparent and public information concerning its membership, board members, method of decision-making, how much funding it receives and from whom, how members of the public can participate in its decision-making, and how members of the public can join the organization and participate in its activities.⁷ RIOs would not be permitted to engage in partisan advocacy activity.

The distinction between self-interested, pleasure and recreation non-profit groups, self-interested commercial groups, and those with an altruistic, public policy-oriented perspective, forms the basis for the proposed test which RIOs would need to meet in order to obtain RIO tax status: *will the members or potential members of the group materially benefit from the successful promotion of the advocacy activities of the RIO any more than non-members?*⁸ If not (this reflects its non-commercial, public interest, social welfare and civic improvement orientation), then the group falls within the RIO category. Thus, for example, successful promotion of environmental, health and safety or consumer public policy objectives by registered public interest organizations would in most circumstances not benefit the members or potential members of a RIO any more than it would benefit non-members (i.e., all citizens would benefit from improvements to environmental, health and safety, or consumer public policy improvements). On the other hand, yacht clubs, miniature railroad clubs, gun clubs (non-commercial self-interest), or industry associations (commercial self-interest) are created to benefit their members and potential members above those of others in society and have no public policy objectives. So those with a self-interested perspective would remain outside of the RIO category, and would not receive any ability to issue tax deduction receipts for donations.

With this background, we are now in a position to consider the value of introducing the RIO category, as part of a more systematic approach to tax treatment of a wide range of non-profit organization types.

The Value of a More Nuanced, Graded Approach to Tax Treatment of Non-Profit Organizations Engaging in Public Policy Development

⁷ It is proposed that the code of accountability be developed through a multi-stakeholder process, spearheaded by a leading non-governmental organization perhaps operating in conjunction with a university.

⁸ For a more detailed exploration on the distinction between public interest organizations and those with a self-interested orientation, see P. Finkle, K. Webb, W. Stanbury, P. Pross, ***Federal Government Relations with Interest Groups: A Reconsideration*** (Ottawa: Consumer and Corporate Affairs, 1994), pp. 16 - 30. Available at: <http://www.carleton.ca/~kwebb/publicationsofwebb/webb.html>

Above all, the objective of introducing the RIO category, and making attendant adjustments to the non-profit and charities categories at the same time, is to create a more modern, responsive, equitable and graded approach to tax treatment of non-profit organizations. Such an approach reflects more accurately the wide variety of non-profit organizations in existence, from those with no evident public policy value (i.e., clubs or associations with pleasure and recreation objectives, which are exempt from paying income tax under Part I of the *Income Tax Act* but cannot provide tax receipts for donations), to registered interest organizations (which have a social welfare and civic improvement focus, and therefore would be permitted to issue tax receipts, albeit at a lower rate than charities, and would be required to abide by a code of accountability, and could only engage in non-partisan advocacy activities), to charities (which have a primary service function, are subject to liberalized rules concerning advocacy, and have the ability to issue tax receipts for donations at the highest rate), and commercial interest organizations (i.e., industry associations, which receive membership fees and other financial contributions from member-firms which are deductible as business expenses by those firms). Clubs with pleasure or recreation objectives have a fundamentally self-interested purpose, whereas the beneficiaries of RIOs (and charities) are those beyond its members or potential members.⁹ Below is an attempt to depict the main groupings of a more modern approach to tax treatment of non-profit organizations.

⁹ Industry associations currently receive funding from businesses, and the funding provided is deductible by those businesses as a legitimate business expense. Industry associations have a self-interested commercial orientation, whereas clubs with pleasure or recreation objectives have self-interested non-commercial orientation.

Toward a More Modern and Systematic Approach to Tax Treatment of Non-Profit Organizations Engaging in Public Policy Development in Canada -- A Graphic Representation

<p>Recreation/pleasure non-profit clubs – exempt from paying income tax under Part I of the <i>Income Tax Act</i> (ITA), but has no ability to issue tax receipts. As per current ITA rules for NPOs, advocacy not subject to restrictions.</p>	<p>Registered Interest Orgs– civic improvement and social welfare objectives – ability to issue tax receipts, lesser amount than charities. Non-partisan advocacy are permitted, but RIOs are subject to code of accountability.</p>	<p>Charities – service orientation, with liberalized ancillary advocacy rules. Ability to issue tax receipts, at higher amount than RIOs. Re-vamped model would have a more narrowly defined education category. Registered Arts and Amateur Athletic Orgs remain unchanged.</p>	<p>Commercial interest organizations (industry associations) – businesses can deduct the expenses of membership in such groups.</p>
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As the above graphic representation hopefully makes clear, the RIO category, and attendant modifications to the existing non-profit and charities categories, creates "room" for those non-commercial public interest organizations oriented toward public policy debate and development which do not have a service orientation.

Arguments For and Against Creation of the RIO Category

We will now look in greater depth at some of the arguments for and against the inclusion of the new RIO category (and attendant modifications to the existing non-profit and charities categories).

First and foremost, an argument can be made that introduction of the RIO category would alleviate much of the pressure which currently exists for non-profit organizations to mis-describe their objectives, under-report their advocacy activities, or suppress their advocacy activity, so as to qualify for or maintain charitable tax organization status. It seems apparent that any liberalizing of advocacy rules of charities will serve to make the registered charity category an even more coveted status for those who currently do not have it, and so increase the incentive for groups to mis-describe in the hopes of obtaining the status. (referred to earlier as the “Cinderella’s slippers” phenomenon).

Second, creation of the RIO category would alleviate the current seemingly inequitable situation, to which we have already referred, which sees certain groups engaging in socially valuable activities receive tax preferable charitable status while others do not, despite being engaged in socially valuable activities.

Third (and this is closely related to the second), it would allow the “education” category of charities to revert back to its original, self-evident focus – i.e., schools, universities, training institutions, and other places of learning – and not continue to be distorted to encompass groups which, while engaging in socially valuable activities such as studies concerning how laws could be reformed or how current programs are not working, are nevertheless not engaging in “education” in any normal sense of the word. Hence, thinktanks, environmental organizations, anti-pornography groups, anti-smoking groups, pro- and anti-abortion groups, which are an uncomfortable fit under the education category of charities, would all seem to fit more comfortably under the RIO category.

Fourth, introduction of the RIO category acknowledges the legitimate role played by interest groups in the political process, to expand non-partisan input in public policy processes. This is a point which even major Canadian media sources such as the Globe and Mail acknowledges is legitimate.¹⁰

Fifth, introduction of the RIO category puts public interest organizations on a more even footing with commercial interest organizations (industry associations), which are already beneficiaries of the tax system in that businesses can deduct the costs of engaging in lobbying activity (including the expenses of belonging to industry associations).

Sixth, arguments that the federal government shouldn’t be creating new, specialized categories of non-profit groups carry no weight, since the federal government has already created the Registered National Arts Service Organization, and the Registered Amateur Athletic Organization.¹¹ Hence, precedents exist for federal action to create a more nuanced approach to recognizing within the tax system the variety of non-profit organizations in existence, and there is no apparent obstacle to creation of specialized categories.

It is true that at one level, creation of the RIO category would undoubtedly lessen the revenue generation capability of the federal government, since it would increase the number of groups which could issue receipts for tax deductions or credits for donations. However, at another level, it could perhaps reduce the need for direct government contributions and grants to these groups, and orient the groups more towards the public (since it would be members of the public which would fund them, through donations). The code of accountability would aid

¹⁰ E.g., see editorial, Globe and Mail, “The charity minefield,” April 3, 2002, p. A12.

¹¹ These are both discussed at greater length in K. Webb, *Cinderella’s Slippers, op cit.*

taxpayers in determining which group (if any) would receive donations. The ability of the group to generate donations would be directly related to the degree to which their policies and practices resonated with the taxpaying public, and not their popularity with government funding agencies.

To synthesize the foregoing, the RIO proposal is based on several fundamental premises:

1. The current lumping together of self-interested pleasure and recreation clubs with civic improvement and social welfare organizations is inappropriate and inequitable;
2. There is a legitimate role for advocacy groups in the political process, to expand non-partisan input to public policy;
3. Current and proposed rules for liberalizing the advocacy activities of charities, while laudable, create an incentive for interest groups to mis-describe their activities in the hopes of attracting charitable tax status;
4. Creation of the RIO category would reduce the inequities which sees some groups engaging in seemingly positive societal public policy activity disallowed from charitable status, and others approved;
5. Creation of the RIO category would reduce the need to distort the “education” category of charities to encompass thinktanks, etc.. Instead, such groups would likely qualify for status as RIOs.
6. Creation of the RIO category would put public interest and commercial interest organizations on a more even footing, since both would be able to attract tax deductible funding (currently only businesses can deduct expenses for lobbying);
7. Creation of the RIO category would decrease the need for such public interest organizations to obtain direct funding from government agencies, and instead orient their activities toward the public in general and taxpayers as potential donors in particular.
8. The public would benefit from greater transparency and accountability for the activities of interest groups – the kind of transparency and accountability which comes from complying with the proposed RIO code of accountability.
9. Introduction of the RIO category -- along with a re-framing of the current non-profit organization category as a “non-profit clubs for pleasure and recreation” category, and a reformulation of the charities category with a slimmed down education category and liberalized advocacy rules -- would allow for a more modern, graded, equitable, responsive approach to treating non-profit organizations, with different features for different types of organizations.
10. There are precedents to establishing specialized non-profit organization categories under the *Income Tax Act*, and no apparent barriers to creating them.

Conclusions

The proposed introduction of the RIO category, with the related adjustments to the existing non-profit organization and charities categories, is based on the idea that Canada needs a more principles and functions-based vision of the tax treatment of non-profit organizations involved in public policy activities. The proposed more nuanced and sophisticated approach to

tax treatment of non-profit organizations is intended to represent a symbolic “tearing down” of the current walls which separate non-profit organizations into inappropriate categories, exclude certain groups, and suppress legitimate and positive public policy oriented activities. It proposes creating instead a re-building of a modern framework for non-profit organizations, a framework appropriate for governing in the 21st century. Thus, it is not a question of simply tearing down walls for the sake of tearing them down. Rather, it’s a question of building the appropriate walls for the wide variety of non-profit organizations now in existence.