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THE CONCEPT OF INCOME AS RELATED TO THE NON-CHARITABLE NONPROFIT SUBSECTOR IN CANADA

Lori McMillan*

I. INTRODUCTION AND CONTEXT

WHETHER or not something is “income” is a question that has frequently caused conflict since income taxation began. Usually, determining what constitutes income is important because it establishes liability for taxation. For purposes of this article, however, income classification is important for determining the existence of a public subsidy for certain nonprofit organizations currently exempt from federal income taxation in Canada. Although the nonprofit sector encompasses both charitable and non-charitable organizations, I will use the specific term “nonprofit” in this article to refer to non-charitable entities exempt from taxation by virtue of paragraph 149(1)(f) of the Income Tax Act¹ (ITA) (the “Provision”), explored later in this work.

This paper will examine the concept of “income” and will conclude that: (1) these entities can earn income and would therefore be properly subject to taxation but for the Provision; and (2) as a consequence, the exemption from taxation that nonprofits enjoy is a tax expenditure. Furthermore, the program supported by this spending should be evaluated to determine its effectiveness.

II. NONPROFITS GENERALLY

There are three sectors to the economy: private, public, and nonprofit. The nonprofit sector has been given other names in an attempt to describe its role with absolute precision,² but that is not the focus of this work, thus I will use this term throughout. The nonprofit sector contains both charitable and non-charitable actors, and by virtue of the way the private and public sectors are defined it is a sector composed of residual actors, meaning if one is not a member of the governmental sector or the

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1. Income Tax Act, R.S.C., ch. 1, § 149(1)(f) (1985) (Can.).

2. Jacqueline Thayer Scott, *Session A: Defining the Nonprofit Sector, in The Emerging Sector: In Search of A Framework*, 48-50 (Ronald Hirschhorn ed.) (1997), available at http://www.cprn.org/documents/25944_en.pdf. See also Richard Steinberg & Bradford H. Gray, *The Role of Nonprofit Enterprise in 1993: Hansmann Revisited*, 22 NONPROFIT & VOLUNTARY SECTOR Q. 4, 298 (1993).

private sector, then one is a member of the nonprofit sector.³ Charities are the most visible actors in the sector, but are not the only ones.⁴ Within the sector, the members typically have a non-distribution constraint, which prohibits profit-taking by owners, operators, or members of the individual entities.⁵ Charities, at least ones that wish to be able to issue tax receipts for donations, must be registered with the Canada Revenue Agency,⁶ but the *Promaster Memory Card* other members of the sector may be much more informally organized to the point of being ad hoc. I will further distinguish between charities and non-charities by referring to the latter as 'nonprofits', which is how they are referred to in the heading of the Provision. These nonprofits can be clubs, societies, or associations.⁷ Associations have been judicially interpreted to include corporations,⁸ which are the most organized type of entity contemplated in this Provision, while clubs and societies can be loose and unorganized. The use of these three qualifying entities ensures that the types of organizations which can avail themselves of the benefit of the Provision are virtually unlimited, with the exception of inter vivos trusts and partnerships.

III. THE PROVISION

The Provision exempting the income of nonprofits from federal income taxation reads as follows:

No tax is payable under this Part on the taxable income of a person for a period when that person was

Nonprofit organizations

(l) a club, society or association that, in the opinion of the Minister, was not a charity within the meaning assigned by subsection 149.1(1) and that was organized and operated exclusively for social welfare, civic improvement, pleasure or recreation or for any other purpose except profit, no part of the income of which was payable to, or was otherwise available for the personal benefit of, any proprietor, member or shareholder thereof unless the proprietor, member or shareholder was a club, society or association the primary purpose and function of which was the promotion of amateur athletics in Canada.⁹

3. Scott, *supra* note 2, at 48-50.

4. *Id.*

5. Henry Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 *YALE L.J.* 54, 56 (1981).

6. Income Tax Act, R.S.C., ch. 1, § 118.1(1). This grants a charitable donation tax credit for gifts to registered charities and certain other entities. "Registered charity" is in turn defined in ITA § 248, which requires application to the Minister of National Revenue in prescribed form.

7. Income Tax Act, § 149(1)(l).

8. *Minister of Nat'l Revenue v. St. Catharines Flying & Training Sch. Ltd.*, [1955] S.C.R.738 (Can.).

9. Income Tax Act, § 149(1)(l).

Thus the Provision bestows exemption on any person who can bring itself within the wording of the paragraph, as no registration or recognition is required.¹⁰ Any person who claims exemption by virtue of the Provision must file an information return for a taxation year in which the person received certain passive income in excess of \$10,000, had assets with a book value of \$200,000 at the close of the preceding fiscal year, or had been required to file the information return in a previous year.¹¹ Accordingly, there are likely a large number of entities claiming the benefit of the Provision which are not known to the Canada Revenue Agency. Estimates of the size of the nonprofit sector in 2003 range from 161,000¹² to 200,000 entities,¹³ and further estimates place the percentage of charitable nonprofits to the nonprofit sector at just over half,¹⁴ leaving just under half the entities as non-charitable nonprofits, likely numbering between 80,000 and 100,000 entities.¹⁵ The number of information returns that were filed in 2003, however, was a mere 12,399,¹⁶ leading to the conclusion that significant authoritative statistical information on the non-charitable subsector is presently unavailable.

The requirement that a nonprofit entity be a club, society or association is very broad, and excludes very few organizational forms, while the need for the nonprofit organization (NPO) to be organized and operated for a purpose other than profit is both strict and lax.¹⁷ The mandatory technical requirements are strict and must be met, including that no dividends or other personal benefits can inure to shareholder/owners, the operations of the organization must accord with its purpose, and that the organization claims a purpose other than profit.¹⁸ The purpose requirements, however, are lax; there is no broad mandate that entities must

10. *Id.*

11. *Id.* § 149(12).

12. National Survey of Nonprofit and Voluntary Organizations (NSNVO), *Cornerstones of Community: Highlights of the National Survey of Nonprofit and Voluntary Organizations*, No. 61-533 XPE, at 8 (2005) available at <http://www.statcan.gc.ca/pub/61-533-x/61-533-x2004001-eng.htm> [hereinafter National Survey]

13. Scott, *supra* note 2, at 8.

14. Imagine Canada, *How Many Charities and Nonprofits are there in Canada and the Provinces*, NONPROFIT LIBRARY COMMONS, 2003, http://nonprofitscan.imagine-canada.ca/tir_how_many_charities.

15. According to data supplied by Canada Revenue Agency (CRA), in 2005 approximately 82,200 registered charities existed in Canada. Using the information from the National Survey, and taking 161,000 to be the whole of the sector, it would seem that just under 80,000 non-charitable nonprofit entities exist in Canada. The study states elsewhere, however, that forty-four percent of all nonprofit organizations are non-charitable entities, which would result in 70,840 non-charitable nonprofits, still a significant number. The truth undoubtedly rests somewhere between the two figures, but ultimately the size of the entire sector is significant, as is the specific part of the sector being examined here. *Registered Charities Newsletter*, CANADA REVENUE AGENCY, No. 27, Fall 2006, at 2, http://www.cra-arc.gc.ca/E/pub/tg/charitiesnews-27/charitiesnews-27-e.html#P151_3567.

16. Data from ATIA request A-041872 (on file with author) [hereinafter ATIA].

17. *GST for Not For Profit Organizations and Registered Charities*, BDO Dunwoody LLP, <http://www.bdo.ca/markets/notforprofit/documents/BDODunwoody-GSTfor nonprofitorganizations.pdf>.

18. *Id.*

fulfill, and no quid pro quo that must be given.¹⁹ As long as any object other than profit is stated in conjunction with the other requirements, the organization will be exempt under this provision.²⁰

The jurisprudence on ITA paragraph 149(1)(l) and its successors has evolved over the years, largely causing the types of entities exerting a claim to the exemption to change significantly. The biggest evolution revolves around the type of activities that a NPO can engage in, and by extension the types of entities attempting to claim the exemption, through the interpretation given to the purpose test.²¹ When the Provision was first enacted in 1917, small grass-roots type entities sought to claim its benefit, but by the end of the 20th century large commercial operations operating for the benefit of private groups were unabashedly litigating to seek its application.²² Case law requires a few elements to be present before exemption is granted under this provision. The nonprofit purpose must actually be pursued by the entity claiming the exemption as merely funding another entity to carry out the nonprofit purpose is insufficient.²³ Commercial activity is acceptable in a nonprofit entity, and it does not matter whether it operates in an industry in competition with members of the private sector, as long as the 'organized and operated' elements are properly structured, and the true focus of the entity is its stated nonprofit objectives.²⁴ The purpose of an entity may be focused solely on the benefit of a private group, such as lawyers, which are not underprivileged and have no identified need for social support.²⁵

IV. THE INCOME DEFINITION THEORY AND CANADIAN NONPROFITS

The scholar who proposed that nonprofits do not earn income as we understand the concept to be was American Boris Bittker; he focused on the definitional difficulties faced by organizations whose revenue is generated mostly from donations.²⁶ Bittker asserted that the concept of income is an uneasy fit because the underpinnings are for entities that exist to maximize profit, and these do not translate to nonprofit entities: "When the familiar methods of income measurement proscribed by the

19. *Id.*

20. *Id.*

21. Income Tax Act, § 149(1)(l).

22. *E.g.*, Income War Tax Act, 1917, 7-8 George V., c. 28, assented to Sept. 20, 1917; Conner, Carter & Walters, *New Canada Not-For-Profit Corporations Act and Its Impact on Charitable and Non-profit Corporations*, CANADIAN ASS'N, Jan. 2005, http://www.axi.ca/tca/jan2005/guestarticle_3.shtml.

23. *E.g.*, *Woodward's Pension Soc'y v. Minister of National Revenue*, [1962] CTC 11 (Can); Eliza Erskine, *Can a Canadian Non-Profit Earn a Profit? CRA's Views on The Subject*, GLOBAL PHILANTHROPY, Nov. 11, 2009, http://www.globalphilanthropy.ca/index.php/blog/comments/can_a_canadian_non-profit_earn_a_profit_cras_views_on_the_subject/.

24. Erskine, *supra* note 23.

25. *Id.*

26. Boris Bittker & George K. Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 *YALE L.J.* 3, 307-14 (1976).

Internal Revenue Code, the accounting profession, or administrative practice are applied to nonprofit organizations, these methods must be stretched to, or beyond, the breaking point.²⁷ The primary cause of this disjunct was the issue of how to classify donations for public service organizations, whether as income, gifts that would be exempt from taxation, or capital contributions.²⁸ On the other hand, he also stated that the expenditures incurred in carrying out the nonprofit mandate of an organization would not be allowable deductions under existing taxation concepts, as they were not incurred for the purpose of making a profit,²⁹ the basic standard for allowing deductions from income. In Bittker's opinion, these problems mean that income cannot be accurately determined for entities which rely on donations as a primary source of revenue.³⁰ But the article in which Bittker made this assertion is very clear that only donative nonprofits experience this problem, not mutual benefit organizations,³¹ which is Bittker's classification, and where many of the non-charitable nonprofit entities at the focus of this article would fit. In Bittker's terms, donative nonprofits are a type of public service organization which receives the bulk of its revenue from donations and gifts. Another broad category, mutual benefit organizations, exist to provide goods or services to their members, and are controlled by these members.³² The non-charitable nonprofit entities at the center of this examination do not earn a significant proportion of their revenues from donations or gifts, but rather from active and passive income.³³ Although some Canadian academics have discussed the taxation of the nonprofit sector as a whole and seem to understand and apply this income definition theory to the whole sector rather than just donative entities, this is simply not what the theory was meant to do. Bittker's income definition theory focuses exclusively on donative entities, which are entities that receive the bulk of their revenue from donations; he specifically states in this article that mutual nonprofits should be treated as flow-through entities for tax purposes, with individual members having an entity's income imputed to them.³⁴

27. *Id.* at 307-8.

28. *Id.* at 308-9.

29. *Id.* at 310-12.

30. *Id.* at 314.

31. Bittker's classification of entities are subject to the same non-distribution constraint as donative entities, but which exist for the benefit of their members rather than for public service. *Id.* at 305-6.

32. Bittker, *supra* note 26, at 305-6. *See also* Hansmann, *supra* note 5, at 60 n.25.

33. For example, data provided by Canada Revenue Agency pursuant to Access to Information Request A-041872 demonstrates that, for the 2006 tax year, gifts to entities claiming exemption under ITA para. 149(1)(l) totalled just 0.34% of the total revenue of these entities who filed the information return Form 1044. Active income made up 49.68% of revenues, and passive income made up 5.94%. This demonstrates the relative insignificance of gifts to these entities, and the fact that they do not rely on donations for much of their revenue. While some categories of entities within this class had higher percentages of gifts than others, at no time did gifts form a significant part of the income of any category of entity type, and certainly did not rival active income as a revenue source. ATIA, *supra* note 16.

34. Bittker, *supra* note 26, at 306-07.

His theory recognizes that income can be earned by such organizations, but the tax circumstances surrounding them would be the same as partnerships, which have some legal personality but are not taxed as a separate legal person.³⁵

Bittker's income definition theory has an alternative position which centers on the concept of 'ability to pay' as something that must be determined before an entity can be subjected to taxation.³⁶ His primary concern is that the true incidence or burden of taxation would be felt by the beneficiaries of the public service works performed by the nonprofit entity, and it would be impossible to determine with any accuracy their ability to pay, let alone who these beneficiaries are.³⁷ Since their ability to pay is not able to be accurately determined, as his theory states, it is not appropriate to tax these organizations since they can properly be viewed as mere conduits for the persons they service.³⁸ While ability to pay is a key tax policy concept, it is not one that has been often used in evaluating entity-level taxation, but rather personal taxation; entity level taxation does not generally take into account the ability to pay of the entity's underlying shareholders and is not considered particularly progressive.³⁹ As such, there is no precedent to view incorporated nonprofits as the mere aggregate of their beneficiaries for tax purposes, which would require taking their ability to pay into account when determining the income of the overarching entity. If the activities of the nonprofit are carried on through an unincorporated association, ability to pay is taken into account by attributing income to each of the participating members or partners, to be included in their regular income and taxed at their ordinary progressive rates.⁴⁰

Finally, it also must be stressed that this alternate assertion also focuses on public service nonprofits, which are not typically the entities that enjoy exemption under paragraph 149(1)(l) of the Income Tax Act.⁴¹ The entities which are exempted under paragraph 149(1)(l) run the gamut from community-oriented entities with open beneficiaries (community improvement, social welfare organizations) to mutual entities with restricted beneficiaries (social and recreation clubs, and organizations with any purpose other than profit), which demonstrates at least for the restricted membership mutual entities that the underlying beneficiaries can in fact be determined with absolute accuracy.⁴² To the extent that some organizations exist to benefit their members only, and these members can be determined, this alternate theory does not fit the exemption given to the non-charitable nonprofit subsector of the nonprofit sector through

35. *Id.*

36. *Id.* at 315.

37. *Id.*

38. *Id.*

39. Hansmann, *supra* note 5, at 64-65.

40. *Id.*

41. Income Tax Act, § 149(1)(l).

42. *Id.*

the Provision. This demonstrates a need to rationalize the exemption accorded to these entities, as there is no focus or goal which can be seen to be encouraged through the existence of the exemption.

As demonstrated in Hansmann's article, the income definition theory does not apply to nonprofit entities which are exempted by operation of paragraph 149(1)(l), as it was only meant to apply to entities which receive the bulk of their revenue from donations.⁴³ In addition, Hansmann has authoritatively contradicted this theory,⁴⁴ and no other academic has published a defense of its core assertions to date. Therefore, using this theory to assert that income is not something that can be earned by the nonprofit sector in Canada does not work.

V. INCOME: BACKGROUND THEORY

Even if Bittker's version of the income definition theory does not apply to Canadian nonprofits, is it still possible that these entities do not earn income as conceived in the Canadian system? To answer this question, a theoretical and practical exploration of the underpinnings of 'income' in the Canadian system, put into the context of the nonprofit sector, is required.

A. THEORETICAL CONTEXT: THE BEGINNING OF A DEFINITION OF INCOME

In order to levy a tax on income or to exempt a certain type of income, one must first define the word. This definitional exercise is one of the most basic stumbling blocks to achieving consensus in the tax policy area. A layperson might think that "income" can easily be defined, encompassing mostly the wages she brings home and any interest or dividends she might collect. But, academics view these types of receipts as the mere beginning of what constitutes income, and one must look at what the definition will be used for, if at all. For legal academics, income is a concept which must properly form the basis for a tax system, and therefore has a practical purpose that requires black and white application.⁴⁵ One must also take into consideration other practical and theoretical concepts, such as equity, simplicity, and political considerations. Various policy goals will cause the actual income tax to depart from the academic "ideal concept" of income, but the ideal must still be understood in order to know what it is that one is 'missing'; in many ways, it is trying to understand the "theory of the second-best" in action.⁴⁶

43. Hansmann, *supra* note 5, at 59-63.

44. *Id.*

45. *See, e.g.,* Bittker, *supra* note 26, at 305-14.

46. This is an economic theory that focuses on "what happens when the optimal conditions are not satisfied in an economic model." This model was established by Kelvin Lancaster and Richard Lipsey in 1956. Generally, this theory would apply "whenever all of the equilibrium conditions satisfying economic nirvana cannot occur simultaneously," such as in the case of market imperfections or distortions. The best outcome obtained would be less efficient than in the ideal, thus the moni-

Income is a social construct, created by legislation and defined by each nation to reflect priorities and values inherent to their respective societies, and accordingly, will differ from country to country.⁴⁷ Under the statute used to impose and collect taxes in Canada, the Income Tax Act, non-charitable nonprofit entities earn income that would otherwise be subject to taxation, but that income is exempted from taxation under ITA paragraph 149(1)(I) as long as the recipient is organized and operated for a purpose other than profit.⁴⁸ This will be examined in greater detail later in this article.

B. RELEVANCE

The definition of “income” is likely to be most relevant in the real world in order to calculate liability under an income tax. Income differs from the concept of “wealth,” which, at its basic level, assesses the depths of one’s overall financial picture.⁴⁹ Income deals with a calculation for a specific period of time, a snapshot that usually encompasses a year, and may or may not include every penny that touches a taxpayer’s hands during that time, as well as certain amounts that do not.⁵⁰ Income is usually defined by legislation, and certain receipts are included in a taxpayer’s income, while others are left out entirely.⁵¹ Value judgments are made in the development of this legislation; for example, is a dollar found on the sidewalk considered “income” and therefore properly subject to taxation? Would the answer change if the finder of that dollar gave it to a homeless person on the next corner? Or if she bought a coffee with it at the corner store? Or if she directed the homeless person to pick it up himself? In each of these scenarios, the individual made a specific consumption choice and determined where the dollar would be consumed, or by whom, so why should the treatment differ, if at all? Should a child’s birthday money from his mother be counted as income to the child? Should it matter if that child is eight or twenty-eight? Or, is it true that “a buck is a buck is a buck,”⁵² such that it is appropriate to classify any and all receipts as income to a recipient? The reasons behind why the tax

ker of “theory of the second-best.” Steven M. Suranovic, *The Theory of the Second Best*, *INT’L TRADE THEORY AND POL’Y*, Feb. 16, 2007, <http://internationalecon.com/Trade/Tch100/T100-2.php>.

47. For example, Canada does not define ‘income’ to include lottery winnings, while the United States does. Netherlands imputes income to taxpayers from owner-occupied housing, which neither Canada nor the United States include in their definitions of ‘income’. See M. Peter van der Hoek, *Taxing Owner-Occupied Housing: Comparing the Netherlands to Other European Union Countries*, *PUB. FIN. AND MGMT.* 4, 7 (2007): 393-421, MPRA Paper No. 5876, available at <http://mpra.ub.uni-muenchen.de/5876/>.

48. The Provision refers to these entities as non-profit organizations. Income Tax Act, § 149(1)(I).

49. *BLACK’S LAW DICTIONARY* 1624 (8th ed. 2004).

50. *Id.* at 778.

51. Such as windfalls, like lottery winnings, under the Canadian tax regime.

52. A phrase popularly attributed to the findings of the Carter Commission. Kenneth Carter, *Royal Comm’n on Taxation*, Report of the Royal Comm’n on Taxation, Queen’s Printer, Ottawa (1966).

system contains the elements it does or does not contain certain other elements are as much tax policy as politics. These questions need to be explored when looking at a provision in order to understand what that provision is supposed to accomplish, in order to assess and determine whether or not it accomplishes its purpose and should remain, or if it needs to be amended or abolished. Thus, it is necessary to enunciate the tax policy behind the exemption for nonprofit organizations in order to evaluate the provision, which although necessary is beyond the scope of this paper.

C. THEORETICAL STARTING POINT: HAIG-SIMONS FORMULATION

The most widely accepted theoretical formulation of income is the one put forth by Henry Simons in 1938, based on the earlier works of Robert Haig and George von Shantz.⁵³ Commonly referred to as the Haig-Simons definition of income, or the comprehensive definition of income, this states that income for a given period is the sum of a taxpayer's change in real wealth and her consumption during this period. This can be expressed as the following algebraic sum:

$$AI = C + \Delta W$$

where AI is the taxpayer's annual income, C is the value of her annual consumption, and W is the real value of her wealth.⁵⁴ Controversy arises, however, in defining the terms used in the formula, specifically what constitutes "consumption"⁵⁵ and what constitutes "wealth".

Determining 'income' is important for many reasons; for our purposes, two reasons stand out. First, for discussion purposes, it is important to have a framework for understanding the discussion behind the definition of income; for as discussed above Bittker disputes the notion that nonprofit organizations can even have 'income' because the concept is unique to profit-oriented ventures.⁵⁶ Second, when examining the cost of the tax preference for nonprofit organizations, a benchmark norm must exist to be able to quantify the deviation from the norm. An absolute figure for this 'deviation,' or 'preference' as a tax person is more likely to call it, is impossible to authoritatively quantify, since the real-world economy is heavily influenced by the presence of big government, through taxes, regulatory requirements, and other overlapping laws, and one must have a great imagination to hypothesize what the normative tax would be in the absence of influence.

53. See Victor Thuronyi, *The Concept of Income*, 46 TAX. L. REV. 45, 46 (1990).

54. *Id.*

55. For example, there is controversy about whether interest should be considered part of a person's consumption. Some state that interest constitutes a reduction in net wealth and is not consumption. Others argue that 'consumption' must include expenditures which produce a current personal benefit, and therefore personal interest should be non-deductible. See Stanley Koppelman, *Personal Deductions Under an Ideal Income Tax*, 43 TAX. L. REV. 679, 716 (1988).

56. Bittker, *supra* note 26, at 302.

In attempting to define ‘income,’ Simons stated that “income must be conceived as something quantitative and objective. It must be measurable; indeed, definition must indicate or clearly imply an actual procedure of measuring. Moreover, the arbitrary distinctions implicit in one’s definition must be reduced to a minimum.”⁵⁷ Some commentators expect that the Haig-Simons definition would confuse, as it is a concept borrowed from the discipline of economics for use in the discipline of law, and without the narrow meanings applied to the underlying concepts used in economic theory, the “meaning collapses when it is applied in the real world.”⁵⁸ The quest for the perfect definition of income is a chimera, however, as the existential question of “what is perfect” will come back to haunt one every time. In dealing with the ideal formulation of “income” one must examine the goals of the tax system as a whole, as well as taking into account numerous tax policy concerns, such as administrative ease, fairness, efficiency, equity, and political constraints, to name a few. It has been recognized that the tax system is more than just a simple revenue raising tool for the various levels of government that employ it;⁵⁹ it is also a social tool used to re-engineer the burdens of society, encourage various types of behaviors, and discourage others.⁶⁰ The search for the perfect definition of ‘income’ would have to be done in a vacuum, which is not possible in the real world. There is no absolute criterion for income and what may be a constituent element of it; it is a social construct, and therefore always open to debate. Simons recognized this, stating that “one must face the fact that income is an actual tax base and that income taxes must finally be appraised in terms of general rules of procedure which best define their nature. Hence arises the need for rigorous, objective definition.”⁶¹ The comprehensive definition is a starting point for establishing income, taking a global approach, which is then modified to suit the needs and norms of each taxing jurisdiction. Under this broad theoretical definition of income, any accession to wealth experienced by non-charitable nonprofit organizations would clearly be income, but since each country is free to define income as it pleases, the practical application of income in Canada could theoretically result in a definition that does not result in income recognition for nonprofit organizations.

57. HENRY C. SIMONS, *PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY*, 42-43 (1938).

58. Thuronyi, *supra* note 53, at 46.

59. “[T]axation serves many purposes in addition to the old and traditional object of raising the cost of government from a somewhat unenthusiastic public.” *R. v. Golden*, [1986] 1 S.C.R. 209, 1986 CarswellNat 236 ¶ 10 (Can.).

60. See David G. Duff, *Tax Treatment of Charitable Contributions in Canada: Theory, Practice, and Reform*, 42 Osgoode Hall L.J. 47, 52 (2001), available at <http://papers.ssrn.com/abstract=293706> (the key purpose of an income tax is “. . . to impose a social claim on a share of each taxpayer’s annual gains from participation in the market economy.”).

61. Simons, *supra* note 57, at 139.

VI. THE CANADIAN DEFINITION OF INCOME

To determine what “income” is, whether or not in the context of non-profits, the ITA is the starting point. But, since nowhere in the ITA is “income” actually defined, jurisprudence must also be examined to expand on our understanding of the concept.

A. THE STATUTE-ITA ss.3(A)

The Canadian approach to income reflects its historical ties to the United Kingdom, eschewing the comprehensive approach adopted by the United States in favor of a schedular approach. As a starting point to defining income in the United States, the Internal Revenue Code states in section 61 that all income shall be included in gross income, regardless of source, except as otherwise provided.⁶² Thus the default position in the United States is that everything is included in the definition of income.⁶³ The Canadian approach comes from the opposite direction; the ITA expresses in section 3(a) that income of a taxpayer arises from an office, employment, business or property,⁶⁴ and despite global language in the provision, it has been relatively narrowly interpreted so that if a receipt is not on this list, it is not included in a taxpayer’s income and as such is not taxable to her.⁶⁵ There seems to be a presumption that something is not income unless it is of the type listed in section 3(a). As the Federal Court of Appeal wrote, “Parliament has chosen to define income by reference to a restrictive doctrine while recasting it in such a manner as to achieve broader ends.”⁶⁶ Thus the Canadian approach uses the ‘source’ concept of income, meaning that a receipt by a taxpayer must be “analyzed and allocated to a source which is either expressly enumerated in the Act or recognized by case law” in order for it to be considered as ‘income’.⁶⁷ This different approach is one reason why Bittker’s assertion that nonprofits do not earn income cannot be imported into Canada without analytical thought, i.e. his assertion was meant to apply in the American context, which views income concepts far differently than do Canadians. This is not to say that his theory fits any better in the American context, but rather that the two different concepts of income must be taken into account when sending theory across national boundaries.

62. 26 U.S.C § 61(a) (2006).

63. *Comm’r v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955). The Court developed a three-part test to determine if something was income: undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion.

64. Income Tax Act, § 3(a).

65. For example, lottery winnings and strike pay are not income. *Fries v. Canada*, [1990] 2 C.T.C. 439 (Can. Tax Ct.). Also, damages stemming from the cancellation of an employment contract prior to the commencement of employment is not income. *Schwartz v. Canada*, [1996] 1 C.T.C. 303 (Can. Tax Ct.).

66. *Bellingham v. Canada*, [1995], 1 F.C. 613, at ¶ 28 (Can. Fed. Ct.).

67. TIM EDGAR & DANIEL SANDLER, MATERIALS ON CANADIAN INCOME TAX 79, (Thompson Carswell, 13th ed. 2005).

1. *Liability to Tax-Persons*

Who is liable to taxation is also important, and this is determined with reference to the ITA. Tax legislation used to be subject to a rule of strict interpretation,⁶⁸ but today is more properly interpreted using the ordinary rules of statutory interpretation, using a teleological approach,⁶⁹ meaning “a legislative provision should be given a strict or liberal interpretation depending on the purpose underlying it, and that purpose must be identified in light of the context of the statute, its objective and the legislative intent.”⁷⁰ With this in mind, like any other statute, the wording of the Provision must be carefully examined and all parts must be given meaning including words like ‘person’ and ‘taxable income.’

Subsection 2(1) states that “an income tax shall be paid, as required by this Act, on the taxable income for each taxation year of every person resident in Canada at any time in the year.”⁷¹ Thus the object of taxation is a resident ‘person.’⁷² ‘Person’ is defined in section 248 to “include any corporation, and any entity exempt, because of subsection 149(1), from tax under Part 1 on all or part of the entity’s taxable income.”⁷³ ‘Taxpayer’ is defined in a slightly different manner, to “include any person whether or not liable to pay tax.”⁷⁴ The terms ‘taxpayer’ and ‘person’ are generally used interchangeably,⁷⁵ and include individuals, which are persons other than corporations.⁷⁶ General charging provisions in the ITA attach to persons, not taxpayers, which mean if someone or something falls within the definition of ‘person’ in the ITA, then they are liable to pay tax pursuant to subsection 2(1) on their worldwide income, as set out in s. 3(a).⁷⁷ This is how liability attaches in the ITA; it does not depend on what kind of person (*i.e.* private, charitable, etc.) earns the income, but whether or not it is a ‘person.’ Since the definition of ‘person’ is extremely broad, and the definition explicitly states that any

68. *See, e.g.,* *British Columbia Railway v. The Queen*, [1979] C.T.C. 56 (Can. Tax Ct.). That traditional view went unchallenged until the decision of the *Supreme Court of Canada in Stubar Investments Ltd. v. The Queen*, [1984] 1 S.C.R. 536, at ¶ 61. In that case the Supreme Court displaced the rule of strict construction with the contextual approach to statutory interpretation advocated by E. A. Driedger in his classic work, *CONSTRUCTION OF STATUTES* 87, (Toronto: Butterworths 2d ed. 1983). *Québec (Communauté urbaine) v. Corp. Notre-Dame de Bon-Secours*, [1994] 3 S.C.R. 3. “The tenets of the ‘teleological’ approach are, now, firmly entrenched in our jurisprudence.” *Bellingham v. Canada*, *supra* note 44, at ¶ 30.

69. *See* EDGAR & SANDLER, *supra* note 67, at 763. Usually statutory interpretation concepts in income tax law are used when determining whether a transaction is within the reach of the ITA. The focus here is much more basic.

70. *Id.*

71. *Income Tax Act*, § 2(1).

72. I will assume for purposes of this paper that all persons are residents.

73. *Income Tax Act*, § 248(1).

74. *Id.*

75. This is usually the case. *But see, Oceanspan Carriers Ltd. v. R.* [1987] 1 C.T.C. 210, 1987 CarswellNat 340 (Can. Fed. Ct.) (where the Federal Court of Appeal ruled that ‘taxpayer’ does not include a non-resident corporation with no Canadian source of income).

76. *See* *Income Tax Act*, § 248(1) (defining individual).

77. *Id.* § 2(1).

entity claiming exemption under subsection 149(1) is a person, there can be no doubt that nonprofit organizations are persons under the ITA, and would therefore be subject to taxation on their worldwide income if no exemption provision existed. This might seem like circular reasoning, as the Provision both gives the exemption and results in personhood, but the definition of person merely states the obvious, that these entities are persons just like entities which exist for a profit purpose, and the definition of person was amended to include this statement in order to require entities seeking exemption under the Provision to file information returns.⁷⁸ The focus of their activities does not have anything to do with whether one group is a person and an identical group with a different focus is not.

2. *The Provision*

Further, an examination of the wording of 149(1)(l) itself is instructive, and necessary under the canons of statutory interpretation. The object of the Provision is a person, as the opening of subsection 149(1) states that the subsection applies to persons, for taxable periods during which that person was one of the enumerated entity types which are set out in the paragraphs following, (l) being nonprofit organizations.⁷⁹ Thus, if there were no person, there would be no availing oneself of the benefits of the exemption granted by paragraph 149(1)(l), which would obviate the very existence of the Provision. In addition, the exemption applies to the taxable income of the person, which means that the Provision itself anticipates that these entities will earn income. There is a presumption that the words are in a provision for a reason, and this means that the only ones who may benefit from the Provision are persons who earn income. Put in another way, if it was not possible for anyone to get the benefit of the Provision (*i.e.* the person cannot earn income), the presumption is that the Provision would not have been created in the first place. Generally, statutory provisions are made to be used.

3. *Source*

As stated earlier, in order for an amount to be income for Canadian income tax purposes, it must be from an office, employment, business, or property source.⁸⁰ If the amount has no source and is not a taxable capital gain, it is not subject to taxation.⁸¹ It is the character of the source that determines income status, not the character of the earner. In the ITA, a 'person' is defined to specifically include any club, society, or association which claims the benefit of the paragraph 149(1)(l) exemption.⁸²

78. This filing requirement was added in § 149(12) by 1992 Technical Bill, effective for fiscal periods ending in 1993 or later. Such an organization must file Form T1044.

79. See Income Tax Act, § 149(1)(l).

80. Income Tax Act, § 3(a).

81. Taxable capital gains are not 'income' but are still subject to taxation.

82. Income Tax Act, § 248(1). "person", or any word or expression descriptive of a person, includes any corporation, and any entity exempt, because of subsection 149(1), from tax under Part I on all or part of the entity's taxable income and the

The two most likely sources of income for a nonprofit to earn are business and property income because a non-corporeal person, such as a nonprofit, would be unable to serve as an employee or hold office.⁸³

In determining whether something is from a source, the Supreme Court of Canada stated, “whether the taxpayer intends to carry on the activity for profit, and whether there is evidence to support that intention” is an appropriate consideration.⁸⁴ That statement would seemingly prevent any amount earned by a nonprofit from being classified as income, because the focus is on the intent to generate profit, and a nonprofit must have as its purpose any purpose other than profit. This seeming conundrum can be clarified by understanding that the definition of profit as used in the case law relating to the source concept of income is from a merely mathematical perspective,⁸⁵ meaning simply that in respect of a revenue stream it generally refers to any amount that remains after allowable expenses (*i.e.* net income) as profit. There are two different focuses for the concept of ‘profit’ in the context of this exemption, and this is the reason for the confusion. Profit, in the context of determining if an entity has made a profit on a particular endeavor, is calculated pursuant to ordinary commercial practices,⁸⁶ which may reflect generally accepted accounting principles as well as specific legislative provisions. In the other context, determining that the purpose of the nonprofit organization is for a purpose other than the generation of profit, such as community improvement, has no impact on whether or not it actually has revenue in excess of expenses with regard to a particular endeavor. The dichotomy of having pure mathematics on one side, and focus and purpose on the other is essential for resolving this; one concept refers to a particular endeavor that the entity enters into, and if the entity intends to make money on the endeavor, while the other refers to the existentialist issues surrounding the creation and *raison d’être* for the organization. The confusion is reflected in the literature in this area. Specifically, in the first Canadian article that addressed NPO taxation, the author, Ronald Knechtel, stated that “since an organization, to qualify for exemption under para.149(1)(l) cannot carry on any activity for the purpose of profit, it appears that it cannot carry on a business within the ordinary meaning of that word. Thus, all of its activities must be non-business activities.”⁸⁷ Case law decidedly contradicts this assertion, since entities

heirs, executors, liquidators of a succession, administrators or other legal representatives of such a person according to the law of that part of Canada to which the context extends.

83. Profit includes income from business and investments. Ronald C. Knechtel, “Tax Treatment of Non-Profit Organizations” in *Report of Proceedings of the Forty-First Tax Conference*, 35:1, at 35:5 (1991) [hereinafter Knechtel]. See also IT-459—Adventure or Concern in the Nature of Trade, Canada Revenue Agency, Sept. 8, 1980, available at <http://www.cra-arc.gc.ca/E/pub/tp/it459/README.html>.

84. *Stewart v. R.*, [2002] 2 S.C.R. 645, 2002 SCC 46, at ¶ 61 (Can.).

85. Knechtel, *supra* note 83, at 35:5.

86. See, e.g., *The Royal Trust Co. v. Minister of Nat’l Revenue*, [1957] Ex. C.R. 70, 9 D.L.R. (2d) 28 (Can. Fed. Ct.).

87. Knechtel, *supra* note 83, at 35:5-35:6.

which carry on active businesses have qualified for nonprofit status;⁸⁸ the distinction is in the drafting and ordering of their objectives and operations, so that the entity's purpose is anything other than profit, even if certain for-profit activities are pursued.⁸⁹ In making his assertion, Knechtel confused the entity's objectives and purposes with the specific activities it undertakes, and continued this confusion throughout his article, so that the idea of "profit" is confusing and indefinite.⁹⁰ This leads to ludicrous results, presuming that everything these types of entities do is destined to lose money. A Trappist monastery in Virginia may intend to sell cheese from its dairy for more than the costs incurred in its production and marketing so that the monastery can take the profit to use for its stated nonprofit purposes.⁹¹ It defies common sense to state that a nonprofit entity cannot earn a profit on an endeavor, which would just be the excess of its receipts over its costs. Nonprofit entities would not engage in the sale of any goods or services if this were the result, which is not the case in reality, as active income forms a significant proportion of the income earned by these types of entities in Canada.⁹²

Jurisprudence on the "source of income" concept states that an income source may recur on a periodic basis, involves a marketplace exchange, generates legally enforceable claims to payment, and arises from a pursuit of profit in a business or property source context.⁹³ This "pursuit of profit" element merely recognizes that the nonprofit tried to earn revenue in excess of its expenses in the related endeavor.⁹⁴ From a statutory and jurisprudential perspective, nonprofit entities are capable of earning income.

88. See, e.g., *Gull Bay Dev. Corp. v. R.*, [1984] C.T.C. 159 (Can.); *Can. Bar Ins. Ass'n v. R.*, [1999] 2 C.T.C. 2833 (Can.).

89. See *Otineka Dev. Corp. v. Canada*, [1994] 1 C.T.C. 2424 (Can.).

90. See Knechtel, *supra* note 83, at 35:8.

91. Jean Denton, *Our Lady of the Angels Monastery: Prayer, Work, & Community*, CATHOLIC VIRGINIAN, Apr. 7, 2008, <http://www.catholicvirginian.org/archive/2008/2008vol83iss12/pages/parishprofile.html>. For other food businesses run by monastic orders, see Mary A. Jacobs, *Gourmet Goodies Gives Monasteries, Convents a Boost*, DALLAS MORNING NEWS, Oct. 28, 2006, http://www.dallasnews.com/shared/content/dws/dn/religion/stories/DN-holychow_28rel.ART0.State.Edition1.3e68790.html.

92. ATIA request, *supra* note 16.

93. See e.g., Peter W. Hogg & Joanne E. Magee, *Principles of Canadian Income Tax Law* 76-77 (2005); Knechtel, *supra* note 83, at 35:5.

94. "[A]n adventure or concern in the nature of trade" is included in the definition of "business" under ITA § 248(1). Income Tax Act, § 248(1). IT-459 states that if a transaction was handled in the same way as a normal business transaction, in terms of quantities or a commodity purchased, method of promotion and sale, etc., there may be evidence of an adventure in the nature of trade leading to the finding of a business. Adventure or Concern in the Nature of Trade: Income Tax Interpretation Bulletin, Canada Revenue Agency, Sept. 8, 1980, available at <http://www.cra-arc.gc.ca/E/pub/tp/it459/it459-e.html>. The Interpretation Bulletin also states, in para. 1, that as a general principle, "when a person habitually does a thing that is capable of producing a profit [i.e. revenue in excess of expenses], then he is carrying on a trade or business." *Id.* at ¶ 1.

B. JURISPRUDENCE ON INCOME, GENERALLY

Since the ITA does not actually define income, one must turn to judicial interpretation. While no single case exhaustively states what is and what is not income, there are certain factors considered when weighing the status of a receipt. Courts will look to see if the taxpayer had an enforceable claim to the payment in question, and whether there was an organized effort to receive the payment.⁹⁵ They will also consider whether the taxpayer sought after or solicited the payment, and whether the taxpayer specifically or customarily expected it.⁹⁶ Other indicia include whether there is a foreseeable possibility of recurring payments, whether the payor was a customary source of income to the taxpayer, and whether the payment was “in consideration for or in recognition of property, services, or anything else provided or to be provided by the taxpayer.”⁹⁷ In short, if the taxpayer does not earn the revenue item as a result of any activity or pursuit of gain on its part, even if for only one transaction, then the item is more likely a windfall than income from a source, and therefore is not taxable. These characteristics depend on the activities of each nonprofit, not on characteristics inherent to the organizational form of the entities claiming exemption. There is no distinction to be made here between for-profit and nonprofit organizations generally, just between individual entities and their activities to generate revenue.

C. JURISPRUDENCE ON ITA 149(1)(L) AND INCOME

The Provision anticipates that exempt entities do in fact earn income: it begins with the very specific words, “No tax is payable under this Part on *the taxable income* of a person for the period.”⁹⁸ The 1917 act creating the original version of the exemption also made reference to the income of nonprofits being exempt from taxation, clearly recognizing that not only will these entities earn income for purposes of the Income Tax Act, they will also earn *taxable* income. The Exchequer Court in the *St. Catharine’s* case further illuminates this point, clarifying that the object of taxation is the person and not the income itself.⁹⁹ The identity of the person who earns the revenue stream does not change the nature of that revenue from being income to not being income; all that changes is whether or not that income is subject to taxation. The court specifically stated that the statutory provision assumes that non-charitable nonprofit organizations will earn income as defined under the ITA, and this income could be taxable except for the exemption provision.¹⁰⁰

95. *Bellingham*, 1 C.T.C. 187 at ¶ 37.

96. *Id.*

97. *Id.*

98. Income Tax Act, § 149(1)(l) (emphasis added).

99. *St. Catharine’s*, C.T.C. 362.

100. *Id.* at ¶ 15.

An examination of the entire body of case law on the Provision and its predecessors over the years shows that in all cases, the question is whether the nonprofit's income is exempt from taxation, not whether the receipts constitute income as defined under the income tax statute.¹⁰¹ The two cases decided on the basis of the definition of income dealt with the question of who had ultimate control of the money, rather than of whether the funds might be taxable in the abstract.¹⁰² It is always possible that money received by any organization, nonprofit or for-profit, does not actually belong to the entity, under the same principles that determine whether income belongs to any person. Specifically, if the person does not have the right to control the funds, and they must be paid over to another person, then these funds simply do not belong to the organization initially receiving them.

No other case law exists considering whether a putative nonprofit's receipt is income in its hands. It is clear from the tone of existing jurisprudence that income characterization is not the focus of the dispute; rather, the focus is the taxability of the income based on the entity's status. This also means that the exemption is extrinsic to the income tax, rather than intrinsic; but for this provision, the income of NPOs would be subject to taxation under the Income Tax Act just as it is for any other non-exempt person. The fact that the body of case law supports income characterization for the receipts of nonprofits helps to build our understanding of the law in this area. Borrowing heavily from and paraphrasing a statement by Justice Rand in a Supreme Court of Canada decision in the related field of municipal taxation,

to characterize. . . [certain bodies] as. . . [nonprofit organizations] merely because of the. . . destination of the net revenues, would be to distort the meaning of familiar language; and to make that ultimate application the sole test of their. . . [nonprofit] quality would introduce into the law conceptions that might have disruptive implications upon basic principles not only of taxation but of economic and constitutional relations generally.¹⁰³

D. ADDITIONAL CONSIDERATIONS: TAX POLICY AND POLITICS

The debate behind the constituent elements of income is framed in terms of definitions, as the definition of words like "wealth" and "consumption" will drive the discussion of what is "income." Many factors can influence what one considers each of these elements to be, or what they should be, and equity may be a consideration in determining these definitions. Equity, at its basic construct, is a codification of what society

101. See e.g., *Can. Bar. Ins.*, 2 C.T.C. 2833; *Gull Bay*, C.T.C. 159; *Woodward's Pension Soc'y v. Minister of Nat'l Revenue*, [1962] C.T.C. 11 (Can.); *Milk Producers Coop. Agric. Ass'n v. Minister of Nat'l Revenue*, [1958] C.T.C. 1 (Can.).

102. *St. Catharine's*, C.T.C. 362; *Minister of Nat'l Revenue v. Begin*, [1963] C.T.C. 148 (Can.). Woodward's also discussed an income definition argument as an alternative argument, which was dismissed by the court. *Woodward's*, C.T.C. 11.

103. *Pasteur v. R.*, [1952] 2 S.C.R. 76, ¶ 40 (Can.).

considers “fair” in particular circumstances.¹⁰⁴ This can be interpreted to be yet another subjective minefield, but there are areas of equity which can be authoritatively stated. For example, it would almost certainly be perceived to be unfair if the government levied a tax of 100% on a person’s income, or if redheads are taxed at seventy-five percent on all their receipts, while brunettes are only taxed at ten percent. The extremes are easy, but problems will arise in establishing equitable treatment for the rest of the spectrum.

Horizontal and vertical equity considerations are both important as they relate to nonprofit organizations. Horizontal equity means that taxpayers with similar abilities to pay should bear similar tax burdens,¹⁰⁵ while vertical equity holds that taxpayers with greater ability to pay should bear a greater tax burden.¹⁰⁶ Since nonprofit organizations are exempt from taxation, both concepts of equity are violated. A regular taxpayer having an ability to pay similar to that of a nonprofit will have to pay tax on her income, while the latter will not. Nonprofits with high revenues will not pay any taxes, despite having a greater ability to do so than taxpayers that earn less but must actually pay taxes. The existence of a nonprofit tax exemption appears to violate both elements of equity. Some scholars, however, have interpreted the Simons definition as having intended equity to weigh in when determining the definition of ‘income.’ Thuronyi, for example, stated in his interpretation of Simons that “income is to be defined in such a manner as to lead to an equitable distribution of tax burdens.”¹⁰⁷ Thus, equity could be satisfied by carefully crafting the definition of income, and not just in the application of a tax on income. From an analytical perspective, however, that approach is more awkward, as it does not allow for a true assessment of horizontal equity, or for true evaluations of policy trade-offs between exempt and non-exempt entities. Be that as it may, a government balances the competing elements that must be weighed in establishing a tax system, and the revenue raised by personal and corporate income taxes fuels the workings of governments around the world. In any case, the tax system is not only used as a method of collecting money, but also as a method of spending money.

VII. TAX EXPENDITURES IN GENERAL

[W]e must review special tax preference. In a fully employed economy, special tax benefits to stimulate some activities or investments mean that we will have less of other activities. Benefits that the Gov-

104. See Richard A. Musgrave, *Horizontal Equity Once More*, 43 NAT’L TAX J. 113, 113-14 (1990).

105. Joseph J. Cordes, *Horizontal Equity*, in *The Encyclopedia of Taxation and Tax Policy* (1999), available at <http://www.taxpolicycenter.org/publications/url.cfm?ID=1000533>.

106. *Vertical Equity*, *ECONOMIST*, <http://www.economist.com/research/economics/alphabetic.cfm?letter=V> (last visited June 14, 2010).

107. Thuronyi, *supra* note 53, at 50.

ernment extends through direct expenditures are periodically reviewed and often altered in the budget-appropriation powers, but too little attention is given to reviewing particular tax benefits. These benefits, like all other activities of Government, must stand up to the tests of efficiency and fairness.¹⁰⁸

Tax legislation has an obvious purpose: to raise money through the imposition of tax on a defined tax base. Less obvious is the purpose tax legislation has in *spending* public money through the granting of various preferences and exclusions. Tax expenditures are a concept developed by U.S. academics Stanley Surrey and Paul McDaniel, which conceptually equates foregone tax revenue with direct governmental subsidy, allowing a dollar amount to be placed on many tax preferences.¹⁰⁹ The Organization for Economic Co-operation and Development (OECD), defines a tax expenditure to be a “transfer of public resources that is achieved by reducing tax obligations with respect to a benchmark tax, rather than by direct expenditure.”¹¹⁰ To illustrate, if the government exempts from taxation the income of a corporation that would otherwise have had to pay \$100 in tax, then the corporation has received a subsidy of \$100, and the government has ‘spent’ \$100 subsidizing that corporation. Conceptually, any tax incentive, subsidy, or other deviation from the normal tax structure which favors a particular group of taxpayers, such as industry, activity, class, or persons, is a tax expenditure. In form, a tax expenditure can be a deduction, credit, deferral, rate reduction, or exclusion from income;¹¹¹ basically any deviation from the normal tax system, in any shape or form, is a tax expenditure and as such is government spending delivered through the tax system. Tax expenditures are primarily used to effect social policy goals and to promote economic development.¹¹² Since tax expenditures are the economic equivalent of direct governmental spending, they should be evaluated by much the same criteria that is used to examine direct governmental spending, which are driven by the concepts of efficiency, effectiveness, and accountability. The U.S. government has been using tax expenditure reports to evaluate tax provisions since 1968, while the Canadian government has been using them since

108. 113 Cong. Rec. H. 16890 (1967) (statement of Rep. Wilbur D. Mills, Chairman, Comm. on Ways & Means of the House of Reps.).

109. See generally STANLEY S. SURREY & PAUL R. MCDANIEL, *TAX EXPENDITURES* (1985).

110. *Best Practices Guidelines – Off Budget & Tax Expenditures*, ORG. FOR ECONOMIC CO-OPERATION & DEV., June 9-10, 2004, at 10, [http://www.oilis.oecd.org/olis/2004/doc.nsf/LinkTo/NT000041AA/\\$FILE/JT00164525.PDF](http://www.oilis.oecd.org/olis/2004/doc.nsf/LinkTo/NT000041AA/$FILE/JT00164525.PDF) [hereinafter OECD Report].

111. These can take almost any form. For example, a sales tax exemption is a tax expenditure, as is a tax holiday; the benefit need not be permanent, as timing differences can give rise to tax expenditures.

112. See, e.g., Stanley S. Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison With Direct Government Expenditures*, 83 HARV. L. REV. 705 (1970); see also D. Larry Crumley, *Behavioral Implications of Taxation*, 48 ACCT. REV. 759-63 (1973).

1979.¹¹³

The entire concept of tax expenditures hinges on a normative tax system as a benchmark to measure deviation. The Haig-Simons definition of income¹¹⁴ is one benchmark that has been proposed, but is by no means accepted by all. Differences in opinion exist as to what the benchmark should be, so it should be no surprise that differences in opinion exist as to what deviations from the benchmark should be. The concept of the benchmark is essential; without a starting point, no deviation can be measured and the exercise is useless. According to the OECD, a benchmark need not necessarily be the normative tax base, but “should be comprehensive and unique.”¹¹⁵ A benchmark tax includes considerations such as “rate structure, accounting conventions, the deductibility of [varying] compulsory payments,” and administrative provisions, to name but a few.¹¹⁶ There is a lack of consensus among countries about what should constitute the benchmark for evaluating tax expenditures, and for the most part this disagreement is rooted in differences of opinion about the normative tax base.¹¹⁷ Defined, “the normative tax base is the monetary sum in the hands of private households to which the tax ought to be applied, for instance income, value added, profit, [or] sales.”¹¹⁸

As discussed earlier, while the Haig-Simons/accretion definition may be well-regarded, there are definitional problems with its conceptual underpinnings, which make it unworkable as a benchmark. The accretion concept takes the sum of the taxpayer’s change in net worth and consumption to be income, so both consumption and savings constitute income. Problems arise in defining both consumption and savings, and since the return on savings is subject to further tax while the return, intangible as it may be, on consumption is not, this leads to what some perceive to be a bias toward consumption.¹¹⁹ Certain subtractions, such as business expenses, are properly allowed as deductions in reaching this base, but do not constitute savings or a change in net worth, and therefore are not “income.” After these “appropriate” deductions, any additional reductions would be categorized as tax expenditures. Arbitrary judgments about whether and to what extent such “appropriate” deductions should be excluded in determining “income” seem to be employed. Should interest be considered consumption, for example? If not, then it should be deductible. How is the valuation of assets to be made on an

113. Albert J. Robinson, *Tax Expenditures and the MacEachen Budget*, 8 *CANADIAN PUB. POL’Y / ANALYSE DE POLITIQUES* 2, 249 (Spring, 1982); 1986 *REP. OF THE AUDITOR GEN. OF CANADA* ¶ 4.141, available at http://www.oag-bvg.gc.ca/internet/English/parl_oag_198611_04_e_4195.html.

114. Bruce Bartlett, *Why the Capital Gains Tax Rate Should Be Zero*, NCPA Policy Report No. 245 (2001), available at www.ncpa.org/studies/s245/s245.html.

115. OECD Report, *supra* note 110.

116. *Id.*

117. *Id.*

118. *Id.*

119. See Vice Chairman Jim Saxton, 111th CONG., *TAX EXPENDITURES: A REVIEW & ANALYSIS* 4 (Aug. 1999).

annual basis; mark-to-market assessment of all taxpayer assets, even above a *de minimus* threshold, would be inconceivably complicated to administer, and it would be unwise to impose a tax that cannot be policed, as evasion would become much more attractive, and faith in the tax system would suffer.

The purpose behind the tax expenditures concept is to hold up to public scrutiny the government's allocation of resources, both through direct concessions and through indirect effects like the distortion occasioned by such allocation.¹²⁰ To the extent that a spotlight is focused on allocation decisions, tax expenditure analysis may be a useful tool in balancing spending priorities against revenue needs. Nonetheless, there are weaknesses inherent in the tax expenditure concept that set limits on its usefulness. First of all, tax expenditures are dependent upon the existence of a defined benchmark norm, and the constitution of this norm is controversial, since inclusion or exclusion from this benchmark tax base is fraught with value judgments unique to each society.¹²¹ This is likely why no two countries define their benchmark the same.

Aside from the insight gained from its application, it is unclear what effect tax expenditure analysis has: it is not quantifiable what tax expenditures would have been in the absence of the scrutiny given them. In addition, while the analysis captures a quantified measure of tax liability reduction stemming from a particular provision, it does not purport to quantify the amount of tax that would be collected should the particular provision cease to exist, behavioral changes that arise as a response to legislative changes are not accounted for, nor are related or complementary provisions adequately determined. Even so, "periodically evaluating the size and effectiveness of tax expenditures is a necessary (although not sufficient) requirement for good government."¹²² In carrying out this "necessary requirement," using the actual tax base as a benchmark is the best tool to identify and quantify tax preferences. The actual tax base as a benchmark shows the best approximation of what effect the Provision has in a real-world context, and the deviation that it causes, to the extent that the Provision is looked at in isolation.

VIII. TAX EXPENDITURE: THE PROVISION

Since nonprofits can earn income as that concept is defined in Canada, this income would be properly subject to federal income taxation but for

120. See e.g., Julie Roin, *Truth in Government: Beyond The Tax Expenditure Budget*, 54 HASTINGS L.J. 603 (2002-2003); Michael J. McIntyre, *A Solution to the Problem of Defining a Tax Expenditure*, 14 U.C. DAVIS L. REV. 79 (1980-81).

121. See Boris Bittker, *A "Comprehensive Tax Base" As a Goal of Tax Reform*, 80 HARV. L. REV. 925, 929 (1967) ("To determine the extent of erosion, we must first have some notion as to what the tax system ought to be. Since this is to a large extent a matter of equity, and since equity judgments are highly personal, no single standard will meet everybody's approval.").

122. Leonard E. Burman, *Is The Tax Expenditure Concept Still Relevant?*, 9/1/03 NAT'L TAX J. 613 (2003).

the existence of the Provision. As a result, the exemption found in the Provision is a deviation from the benchmark norm of income as the Canadian system has, in practice, defined it. It is a tax preference given to nonprofit organizations, and as such is the functional equivalent of direct spending.

A. INCOME TAX THEORY

Classical economic theory discourages high levels of taxation that it views as a disincentive to hard work and entrepreneurship, and thus would encourage supply-side policies.¹²³ Supply-side policies deal with improving the workings of the markets and the economy's capacity to produce, and are aimed at enabling the economy to expand without inflation.¹²⁴ At the heart of classical economic theory is the belief in a free market economy as being the most important factor in fueling economic growth, so that any tax levied by a government should be kept to an absolute minimum. In addition, classical theory has no role for income redistribution.¹²⁵ In the 20th century, taxes have been used as a tool for redistributing income and wealth, because large disparities have arisen under the free market system.¹²⁶ Adam Smith asserted as the rationale behind such redistributive policies that men are essentially equal but for circumstances,¹²⁷ although Smith would likely be turning in his grave if he was aware of the levels that governmental intervention have achieved. In recent years, redistribution has become somewhat less of a concern for governments: the level of distortion and economic inefficiency resulting from redistributive policies is less attractive to government and harder for the electorate to swallow.¹²⁸ Taxes are also used as a tool by governments to manage the economy, encourage economic stability, international competitiveness, economic growth, and development in general.¹²⁹

Tax expenditure analysis focuses on every departure from a normative base as either a tax expenditure or a subsidy. Aside from Bittker, most scholars accept without question that the tax exemption accorded to the nonprofit sector is a subsidy. William D. Andrews posed the question of "whether the provision can intelligently be seen as reflecting a refinement

123. See, e.g., Edmund S. Phelps, *Taxation of Wage Income for Economic Justice*, 87 Q. J. of Econ. 331-354 (1973); A COMPANION TO THE HISTORY OF ECONOMIC THOUGHT 122-126 (Warren J. Samuels et al. eds., 2003).

124. See Robert E. Lucas, Jr., *Supply-Side Economics: An Analytical Review*, Oxford Econ. Papers, New Series, Vol. 42, No. 2, Apr. 1990, at 293-316.

125. See A.B. Atkinson, *Bringing Income Distribution in from the Cold*, ECON. J., Mar. 1997, at 297-321.

126. William R. Johnson, *Income Redistribution in a Federal System*, 73 AM. ECON. REV. 570-573 (1988).

127. John W. Danford, *Adam Smith, Equality, and the Wealth of Sympathy*, AM. J. OF POL. SCI. Vol. 24, No. 4, Nov. 1980, at 674-695.

128. See, e.g., Erich Weede, *Income Inequality, Democracy and Growth Reconsidered*, EUR. J. OF POL. ECON., Vol. 13, Issue 4, Dec. 1997, at 751-764.

129. Eric M. Engen & Jonathan S. Skinner, *Taxation and Economic Growth* (Nat'l Bureau of Econ. Research, Working Paper No. W5826, 1996), available at <http://ssrn.com/abstract=225613>.

in our notion of an ideal. . . income tax, rather than a departure from it."¹³⁰ If not, then and only then can a provision be considered and evaluated as a tax expenditure, according to Andrews.¹³¹ This approach requires examining the object and purpose of the income tax itself, as well as of the provision. The express stated object of the non-charitable non-profit exemption is unknown. It is likely that the Provision is aimed at encouraging socially desirable behavior, rather than merely encouraging a certain legal form of entity to exist.¹³² The purpose of the income tax must also be explored. Many state the primary purpose of the income tax to be a revenue-raising device for the federal government, with secondary purposes being the encouragement of economic development and social redistribution. Some theorists do not see the income tax in quite this light: they view it not as a tax on income per se, but rather as one on,

aggregate personal consumption and accumulation of real goods and services and claims thereto—the uses to which income is typically put rather than the sources from which it is derived. . . [I]t is consistent with the primary, intended, real effect of the tax, which is to reduce private consumption and accumulation in order to free resources for public use. The practical operating base on which the tax is computed consists of income transactions, but the ultimate object of the tax is to lay a uniform graduated burden on aggregate consumption and accumulation.¹³³

Since the income tax exists to effect social policy goals through tax expenditures, amongst other methods, income tax theory could state many reasons why a provision which gives a special preference should exist in a taxing statute. But in this case, the design and delivery of the Provision has become disconnected with any underlying purpose. The design of the Provision has the effect of encouraging a particular form of organization with a non-distribution constraint and operational compliance with stated

130. William D. Andrews, *Personal Deductions in An Ideal Income Tax*, 86 HARV. L. REV. 309, 312 (1972).

131. *See id.*; Bittker, *supra* note 121, at 928 (“Implicit in the reference is the idea that the income tax has an essential integrity; that there is a fundamental standard for determining the tax base and the applicable rates; that maintenance of the standard (restoration where it has been eroded) is important to society, high on its scale of values; that the proponent of a measure which deviates—which creates a preference—has a burden of proof which goes as much to the use of the tax system as the means of accomplishment as to the measure’s specific social or economic objective.”).

132. *See e.g.*, Ontario Law Reform Commission, Report on the Law of Charities (1996), http://www.mtroyal.ca/wcm/groups/public/documents/pdf/npr03_lawcharities.pdf; Duff, *supra* note 60, at 64 (“Since the subsidy is designed to support only activities having a public benefit, however, it is reasonable to require eligible recipients to devote all of their resources to these activities, or related activities for the purpose of activities having a public benefit, and to deny or revoke eligibility to organizations engaging in other activities that are either detrimental to the public good or carried on primarily for private advantage. In order to ensure public accountability for these tax expenditures, it seems reasonable to enforce these requirements by regular audits and to require public reporting of revenues and disbursements by eligible recipients.”).

133. Andrews, *supra* note 130, at 313.

goals.¹³⁴ There is no requirement that these goals advance a social good, or any other social policy. It does not advance a coherent, directed goal. Rather, it overshoots its likely target of encouraging socially desirable behaviors, with the result that it cannot be said to advance a social policy that society would want to support. It would be reasonable to connect the benefit that society wishes to derive from the Provision to the qualifying requirements for receiving the benefit of the Provision, but that connection does not exist. As a result, the effect of the Provision cannot be said to be a redistribution of wealth to benefit society as whole, but rather to create a potential inefficiency which must be re-evaluated.

IX. CONCLUSION

Non-charitable nonprofit entities may earn income as the concept is understood under Canadian tax law, as liability to taxation arises from being a 'person' under the Income Tax Act who earns profit from an office, employment, business, or property source. Non-charitable nonprofit organizations are "persons" under the law, and therefore their earnings, as long as they fit within the listed sources, will be considered "income"; there is no distinction made in determining the character of income based on the character of the earner. As a result, the exemption from taxation that these entities enjoy by virtue of the Provision is a special preference, a tax expenditure. Tax expenditures are used to advance social policy, as the privilege of being excused from common burdens comes with a price. The Provision, as a tax expenditure, must be evaluated to determine if it does effect the likely goals it was meant to achieve, and whether the indirect spending done through this tax subsidy is effective.

134. The requirements of ITA § 149(1)(l) are technical and relate only to form (club, society, or association) giving no personal benefit to owner/members and broad purpose (any purpose other than profit). By having no other requirement for qualification, it cannot be said to encourage anything but what it requires. See also Robert B. Hayhoe, *An Updated Introduction to the Taxation of Nonprofit Organizations*, *PHILANTHROPIST*, Vol. 18, No. 2 (2004).