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THE TAX TREATMENT OF CHARITIES AND CHARITABLE DONATIONS SINCE THE CARTER COMMISSION: PAST REFORMS AND PRESENT PROBLEMS*

BY FAYE L. WOODMAN**

I. INTRODUCTION

From the time of the Carter Commission to the present, there have been a number of major 'reforms' in the tax treatment of charities and charitable donations. This paper will critically examine those reforms and comment on some present problems. The basic premise of this paper is that, for better or for worse, the charitable sector in Canada will, for the foreseeable future, be subsidized through the tax system. This assumption also underlies the recommendations of the *Carter Report*¹ and the legislative proposals, some implemented and some not, of the past twenty years.

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¹ Canada, Royal Commission on Taxation, *Report* (Ottawa: Queen's Printer, 1966) (Chair: K. LeM. Carter) [hereinafter *Report*].

The absence of any significant debate in the *Carter Report*, the 1975 *Green Paper*,² and the 1983 *Discussion Paper*³ on whether the tax exemption for charities and the charitable donation deduction should be retained probably reflects societal consensus in favour of those tax concessions. The consensus, it is suggested here, is the result of a number of generally held beliefs about the nature and role of charitable giving and charitable activities. First, there is a reluctance to view a charitable donation as "consumption"⁴ of a taxpayer. This position, which is not unsupported in the tax literature,⁵ draws a line between "private, preclusive, household consumption"⁶ and expenditure that results in the production of "common or social goods or services."⁷ In the latter formulation, the charitable deduction is logically an integral part of an ideal income tax system.

Second, the existence of tax concessions for charities is often justified on the basis that an important function of charities in Canada is to 'fill in the gaps'. In other words, charities do those things that government would otherwise have to do. In addition, many people believe that charities are more efficient, creative and innovative than government. In that case, not only do charities save the taxpayer money, but they provide better quality.

Finally, charities are said to provide a counterbalance to big government and big business: They encourage the development of

²Canada, Department of Finance, *The Tax Treatment of Charities* (Ottawa: Dept. of Finance, 1975).

³Canada, Department of Finance, *Charities and the Canadian Tax System: A Discussion Paper* (Ottawa: Dept. of Finance, 1983).

⁴Henry Simons's classic definition of income is as follows: "Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question." *Personal Income Taxation* (Chicago: University of Chicago Press, 1938) at 50.

⁵See, for example, W.D. Andrews, "Personal Deductions in an Ideal Income Tax" (1972-73) 86 Harv. L. Rev. 309.

⁶*Ibid.* at 363.

⁷*Ibid.* at 357.

alternative strategies to deal with social and economic problems. They favour individual initiative and autonomy, while at the same time emphasizing mutual assistance and cooperation in the community. Hence charities, it is argued, reinforce the underpinnings of a pluralistic society.⁸

It is questionable whether a consensus will exist in the future. Certainly the new fiscal conservatism favours less government and more private initiative. On the other hand, the past twenty years has witnessed a decline in charitable contributions as a percentage of personal expenditures on goods and services by Canadians.⁹ In that regard, one wonders whether the decline reflects the attitude that taxes have replaced charity. Also,

public support for tax concessions may be affected by possible changes in the nature and activities of charities. Recently, legislation was introduced to permit charities to engage in ancillary political activities. There has been and will continue to be increasing pressure on Parliament to extend the tax advantages enjoyed by charities to other groups who do not fit the traditional definition of a charity.

II. THE CARTER REPORT

Perhaps the most significant thing to note about the sections of the *Report* on charities and the charitable deduction is what they

⁸This was a theme of the Commission on Private Philanthropy and Public Needs (the Filer Commission). The Commission was established in 1973 and reported in 1975, shortly after Watergate. It was a privately initiated (John D. Rockefeller), privately funded citizens' panel with two broad objectives. The first one was to study the role of both philanthropic giving in the United States, and the voluntary, 'third' sector of U.S. society. The second objective was to make recommendations to the voluntary sector, to Congress, and to the U.S. public at large, concerning ways in which the sector and charitable giving could be strengthened and made more effective. See: United States, Commission on Private Philanthropy and Public Needs, *Giving in America: Toward a Stronger Voluntary Sector* (Washington: The Commission, 1975).

⁹A. Weiner, "Dollars to Donors" *The Financial Post Moneywise Magazine* (March 1987) 24 at 28. Weiner refers to a study by Robert Thompson, professor of economics at McMaster University, analyzing donations to charity as a percentage of personal expenditures on goods and services. See also J.F. Deeg, *How and What Canadians Contribute to Charity* (Toronto: Canadian Centre for Philanthropy, 1982).

do not deal with. In the chapter on non-profit organizations¹⁰ there is no discussion of two of the most important issues that have arisen in the past twenty years in the charities area: what could be called the maximum-benefit issue,¹¹ and the issue of charities' political activities. Furthermore, in the chapter on concessionary allowances¹² there is no serious discussion of the possibility of substituting a tax credit for the charitable deduction.

The reason for each of these omissions is different. The Carter Commission did not address the maximum-benefit issue partly because it evidently did not think its mandate extended to consideration of charities' expenditures.¹³ A further factor may have been the relative insignificance of the tax treatment of charities compared with the other issues the Commission was considering: tax rates, the unit of taxation, the tax base and corporate taxation. It is quite probable that the political activities of charities had not arisen as a serious problem up until the time of the Commission. It is also likely that the Commission would have viewed its investigation as beyond its terms of reference. As far as the substitution of a credit for the deduction was concerned, the Commission opined that "[i]f equity was the only consideration, we would propose a system of tax credits for charitable donations."¹⁴ The credit approach, however, would tend to "stifle charitable giving by upper income taxpayers and for that reason the deduction should be retained."¹⁵ The credit-deduction debate, which was given such

¹⁰Report, vol. 4, *supra*, note 1 at c. 20 "Mutual Organizations and Tax-Exempt Entities" 99.

¹¹The proposition here is that every dollar of tax concessions to charities and contributors to charities represents a cost to the Canadian taxpayer. Therefore the rules of taxation should ensure that 'maximum benefit' is derived from them. Maximum benefit is, simply, pay-outs by charities on charity in a reasonable length of time. See *infra*, text accompanying note 45.

¹²Report, vol. 3, *supra*, note 1 at 213.

¹³*Ibid.*, vol. 4 at 134.

¹⁴*Ibid.*, vol. 3 at 222.

¹⁵*Ibid.*

short shrift by the Commission, will be referred to later in this paper.¹⁶

The Carter Commission did make a number of recommendations, most of which were not implemented before or at the time of tax reform.¹⁷ Many of the recommendations had to do with housekeeping matters, and a few dealt with basic policy issues.

One recommendation that was adopted, albeit only partially, was that the limit on deductible charitable donations be raised.¹⁸ The tax reform legislation raised the limit on deductible charitable donations from 10 percent of income in a year to 20 percent of income.¹⁹ This was more generous than the Carter recommendation, which was for an increase to 15 percent for individuals only. Another recommendation was that the issuance of numbered charitable receipts be controlled by the tax authorities.²⁰ In 1966, all charities wanting to issue receipts for tax-deductible donations were required to be registered with the Department of National Revenue and to file annual returns.²¹

Among the recommendations that were not accepted, one of the most important was that charities should pay tax at the corporation tax rate on business income. Business income was defined broadly to include the return on any interest of 10 percent or more in a business.²² The main reason for the Commission's

¹⁶*Infra*, text accompanying notes 141ff.

¹⁷*Income Tax Act*, R.S.C. 1952, c. 148 as am. S.C. 1970-71-72, c. 63 [hereinafter *ITA*]. (This is the core legislation of the present post-Carter Commission, tax reform period.)

¹⁸*Report*, vol. 3, *supra*, note 1 at 235.

¹⁹*ITA*, *supra*, note 17 at s. 110(1)(a).

²⁰*Report*, vol. 3, *supra*, note 1 at 235.

²¹*Income Tax Act*, R.S.C. 1952, c. 148, s. 27(3b) as am. S.C. 1966, c. 47 [hereinafter cited as *Income Tax Act*], s. 3(3); *Income Tax Regulations*, SOR/54-682, s. 216, as am. Order in Council P.C. 1966-2032.

²²*Report*, vol. 4, *supra*, note 1 at 144.

While many charities were carrying on business at the time of the Commission, the legislation proscribed that type of activity explicitly for charitable trusts and corporations, and implicitly for charitable organizations. Charitable organizations were required to devote all

recommendation was to eliminate unfair competition with the private sector although it did advert to the "reasonableness of the retention by charitable organizations of large amounts of their annual revenue."²³

The 1975 reforms²⁴ generally prohibited charities from carrying on a business, but permitted charities other than private foundations to carry on a related business.²⁵ A "related business" was defined to include "a business that is unrelated to the objects of the charity if substantially all of the people employed by the charity in the carrying on of that business are not remunerated for such employment."²⁶

The 1975 reforms also permitted charities to earn business income from related businesses that would not be taxed. In addition, they did not include any rules for the taxation of the non-portfolio business income of charities.²⁷ The legislation resulting from the 1975 reforms did, however, continue the prohibition against charities other than charitable organizations acquiring control of a corporation.²⁸

Another recommendation not reflected in legislation was that an interdepartmental supervisory body be established to grant tax-exempt status to charitable organizations and to review the exemption periodically.²⁹ It was also proposed that once a charity

their resources to charitable activities carried on by themselves. See *Income Tax Act, supra*, note 21 at ss 62(1)(e), (f)(i), and (g)(i). But *cf.* the argument regarding political activities (by charitable organizations), *infra*, text accompanying note 108.

²³*Report, ibid.* at 134.

²⁴The reforms were proposed in 1975 but enacted by *ITA, supra*, note 17 as am. S.C. 1976-77, c. 4, s. 60(1), applicable to 1977 *et seq.*

²⁵*Ibid.* at ss 149.1(2)-(4).

²⁶*Ibid.* at s. 149.1(1)(j).

²⁷The 1975 reforms also did not introduce a disbursement requirement for profits from related businesses.

²⁸*ITA, supra*, note 24 at ss 149.1(3)(c), (4)(c), and (12)(a).

²⁹*Report*, vol. 4, *supra*, note 1 at 144.

was given approval, it be subject to periodic review by the interdepartmental supervisory body. The body could have reasonably been given the task of examining aspects of each charity's operations, such as fund-raising costs and annual disbursements. However, the Commission seemed to be more concerned about detecting outright fraud. It suggested that every charity be required to submit a special certificate signed by its responsible officers and an independent auditor. The purpose of the certificate was to attest to the existence of proper books and records maintained in a satisfactory condition, and to constitute a minimal checking of the accuracy of the statement of operations. A secondary purpose was to confirm that the revenues received by a charity in a taxation year were properly allocated between the exempt category of income (most of a typical charity's receipts) and the non-exempt category (business income).

There are a number of minor Commission recommendations that have never been adopted. One was the Commission's recommendation that the optional standard deduction be reduced to \$50 and that it apply to charitable donations only.³⁰ Continuation of the reduced deduction was favoured on the grounds of administrative expediency. In 1984, the government eliminated the optional standard deduction because "representations of voluntary organizations have expressed concern that this deduction reduces the tax incentive for charitable giving since the deduction is not directly related to actual amounts given."³¹

Another Commission recommendation not implemented was to continue the practice of allowing taxpayers to deduct gifts in kind made to charities. Any such gift, however, would have been required to have a value of more than \$500.³² It is curious that the Commission did not mention, in this context, any consideration of provisions to reduce or eliminate the effect of the taxation of capital gains on the disposition of tangible property to a charity.

³⁰*Ibid.*, vol. 3 at 235.

³¹Canada, Department of Finance, *Supplementary Information to April 19, 1983 Budget* (Ottawa: Dept. of Finance, 1983).

³²*Report*, vol. 3, *supra*, note 1 at 236.

Nonetheless, shortly after tax reform, legislation was introduced that contained a provision to facilitate the transfer to charities of tangible property that could be used by them in their charitable activities.³³ A gift of a painting to a museum would be an example. In 1986, this provision was expanded to include gifts of all types of capital property including intangible capital property.³⁴ The significance of this latter provision will be commented on later in this paper.³⁵

Finally, the Commission's assertion that "[i]t should be made clear that charitable organizations can carry on their work inside or outside Canada" should be mentioned.³⁶ Evidently, the Department of National Revenue was attempting to insist that the activities of charitable organizations had to be confined to Canada. The Commission noted affirmatively, however, the addition of a provision, in 1966, to the *Income Tax Act*, that would permit taxpayers to deduct donations to a foreign charity if the government of Canada had made a contribution to the foreign charity in the taxpayer's taxation year or the twelve months immediately preceding that taxation year.³⁷ At present there are no serious impediments to charities carrying on their activities overseas, themselves or through agents.³⁸

³³*ITA*, *supra*, note 17 at s. 110(2.2) as am. S.C. 1973-74, c. 14, s. 35(7).

³⁴*ITA*, *ibid.* as am. S.C. 1986, c. 6, ss 55(8)-(9).

³⁵*Infra*, text accompanying note 88.

³⁶*Report*, vol. 4, *supra*, note 1 at 134.

³⁷*Income Tax Act*, *supra*, note 21 at 27(1)(a)(vi) as am. S.C. 1966-67, c. 47, s. 3(1) (now s. 110(1)(a)(vii)).

³⁸See M.L. Dickson, "Gifts Involving Foreign Entities" (1986) 6:1 *Philanthrop.* at 48. Also Department of Revenue Canada, Taxation, *Information Circular* 80-10R, *Registered Charities: Operating a Registered Charity* (December, 1985) paras. 18-19.

III. PAST REFORMS

There have been a number of so-called reforms of the tax treatment of charities³⁹ proposed in the last ten years. Not all of them, however, have been implemented. There were the reforms suggested in the 1975 *Green Paper* on charities,⁴⁰ the proposals introduced by the Hon. Mr. MacEachen in his 1981 budget,⁴¹ his subsequent retreat in the press release of April 21 of the next year, the *Discussion Paper* of 1983,⁴² and the 1984 amendments,⁴³ which did not, on the whole, reflect the proposals of the *Discussion Paper*. In addition amendments were proposed in 1985, and subsequently enacted, to permit charities to carry on ancillary political activities.⁴⁴ Thus, in the face of numerous proposals, retreats, and counterproposals, it is difficult to discover any coherent government policy.

In general terms, government policy over the years has been to provide "a tax environment in which charities can thrive"⁴⁵ while ensuring that the Canadian public derives "maximum benefit" from the tax concessions made to charities and taxpayers who contribute to charities. Thus, in the 1975 *Green Paper* the government of the

³⁹Reference will also be made in the following sections to the tax treatment of charitable donations, where relevant. During the period, there were two important changes in the charitable donations deduction. First, for donations made in the 1980 and subsequent taxation years, the carry-forward provision of the charitable deduction in *ITA*, s. 110(1)(a) was extended from one to five years. (S.C. 1980-81-82-83, c. 140. Second, the *ITA*, s. 110(2.2) election was broadened to include intangible as well as tangible property. See *infra*, text accompanying note 87.

⁴⁰*The Tax Treatment of Charities*, *supra*, note 2.

⁴¹Canada, Department of Finance, *Notice of Ways and Means for the Budget of November 12, 1981* (Ottawa: Dept. of Finance, 1981).

⁴²*Charities and the Canadian Tax System*, *supra*, note 3.

⁴³*ITA*, *supra*, note 17 as am. S.C. 1984, c. 45, s. 57.

⁴⁴*ITA*, *supra*, note 34, s. 85(2) at ss 149.1(6) and (6.1)-(6.2).

⁴⁵*Charities and the Canadian Tax System*, *supra*, note 3 at iii.

day justified its approach as follows: "Every dollar of tax relief represents a cost to the Canadian taxpayer. The government therefore believes that it is appropriate that the rules of taxation ensure that the people of Canada obtain maximum benefit from the charities."⁴⁶ The government's attitude was not surprising, given that there were over 35,000 registered charities in Canada in 1975, having potentially tax-deductible donations together exceeding \$500,000,000.⁴⁷ The number of registered charities has increased to over 55,000⁴⁸ and annual donations are estimated to exceed \$2.8 billion.⁴⁹

If the federal government's goal is to obtain maximum benefit from the tax concessions to charities and contributors to charity, then the question arises, what is maximum benefit? On examination of the proposed reforms over the years, the answer seems to be that funds acquired and accumulated by charities should be used for charitable purposes within a reasonable time. The question of the appropriate minimum pay-out over a particular period, however, has been a matter of considerable controversy. Furthermore, the nature of the rules necessary to implement the policy (rules dealing with fund-raising costs, self-dealing, and anti-avoidance) have been in dispute. On the one hand, there has been the desire for very detailed and comprehensive rules governing the operations of charities. On the other hand, there has been a wish for understandable legislation that is easy to administer and to comply with.

⁴⁶*The Tax Treatment of Canadian Charities, supra*, note 2.

⁴⁷*Ibid.*

⁴⁸Weiner, *supra*, note 9 at 24.

⁴⁹*Ibid.* at 27.

A. *From the Carter Commission to the 1975 Green Paper*

In the twenty years before the 1975 *Green Paper*, there was relatively little activity in the area of the tax treatment of charities.⁵⁰ The main change occurred in 1966, when the registration requirement for charities wanting to issue receipts for tax-deductible donations was imposed.⁵¹ Otherwise, the charities provisions were not changed much from the legislation first enacted in 1950.⁵²

The pre-1977 legislation was exceedingly simple. All charities were classified as either charitable organizations,⁵³ charitable trusts,⁵⁴ or charitable corporations.⁵⁵ However, most charities (over 90 percent in 1976) were classified as charitable organizations. The main requirement for a charitable organization was that it had to devote all of its resources to charitable activities carried on by itself.⁵⁶ Since a transfer of money to another charity was not considered to be a charitable activity carried on by the charity itself, some charitable organizations obviously had difficulties in complying with the rule. Different requirements applied to charitable corporations and charitable trusts. While charitable organizations could take varying legal forms, charitable corporations and charitable trusts had, as their names implied, to be corporations and trusts. In addition, charitable corporations and charitable trusts were required to expend 90 percent of their annual income in carrying on charitable activities or making donations to specified donees, mainly

⁵⁰However, in 1972 the maximum charitable deduction for a year was increased from 10 percent to 20 percent of income (*ITA*, s. 110(1)(a)).

⁵¹*Income Tax Regulations*, *supra*, note 21.

⁵²R.S.C. 1950, c. 40, s. 21(1).

⁵³*ITA*, *supra*, note 17 at s. 149(1)(f) (later am. S.C. 1976-77, c. 4, s. 59(1)).

⁵⁴*ITA*, *ibid.* at s. 149(1)(h) (rep. S.C. 1976-77, c. 4, s. 59(1)).

⁵⁵*Ibid.* at s. 149(1)(g) (rep. S.C. 1976-77, c. 4, s. 59(1)).

⁵⁶*Ibid.* at s. 149(1)(f) (later am. S.C. 1976-77, c. 4, s. 59(1)).

other charities.⁵⁷ Neither a charitable corporation nor a charitable trust was permitted to carry on a business.⁵⁸ They were also prohibited from acquiring control of a corporation.⁵⁹

B. *The 1975 Green Paper on The Tax Treatment of Charities*

The legislation enacted after the *Green Paper*⁶⁰ was significantly longer and more complex than the legislation it replaced. Nonetheless, compared with some subsequent proposals, it was a model of simplicity.

Basically, new rules were introduced to deal with three perceived types of abuses.⁶¹ The first was in the area of fund-raising costs. Some charities had inordinately high fund-raising costs, so that the amounts actually given over to charitable uses were small compared with the amounts the charities raised as contributions from the public. Their high fund-raising costs arose for a number of reasons, including inefficiency, bad luck, and certain non-arm's-length transactions. Those transactions sometimes involved the payment of high salaries to trustees or directors of the charities, or the family and friends of the trustees or directors. Furthermore, goods and services might be purchased from such individuals at inflated prices.

Second, some charities with substantial capital assets were paying out comparatively little to charity under the 90-percent-of-income rule. Most of their capital was invested in low-income-yielding loans or securities. The 'profit', if any, arose from the capital appreciation of their assets. Capital gains, of course, were not included in the definition of income for the purposes of the 90

⁵⁷*Ibid.* at ss 149(1)(g)(iii) and (h)(iii) (rep. S.C. 1976-77, c. 4, s. 59(1)).

⁵⁸*Ibid.* at ss 149(1)(g)(iii) and (h)(iii) (rep. S.C. 1976-77, c. 4, s. 59(1)).

⁵⁹*Ibid.* at ss 149(1)(g)-(h) (rep. S.C. 1976-77, c. 4, s. 59(1)); and *ITA* s. 149(7)(a) (rep. S.C. 1976-77, c. 4, s. 59(6)).

⁶⁰*ITA*, *supra*, note 24 at s. 60(1).

⁶¹*The Tax Treatment of Charities*, *supra*, note 2 at 8-11.

percent rule.⁶² The failure to pay out any significant amount to charity was often associated with charities that lacked an independent board of trustees or directors. The main purpose of many such charities was not philanthropy, but to serve as estate-planning vehicles that would facilitate the transfer of wealth between generations without tax liability. Taxpayers could accomplish this result relatively easily. Typically, they would establish a charity that had trustees or directors who were under the taxpayer's effective control. Taxpayers would then, over time, give shares in corporations they controlled to the charity and claim tax deductions for their donations. As a result of these gifts, the liability for tax on death would be greatly reduced.⁶³ Control of the corporations would nevertheless be passed on to the family through the family's membership on the board of the charity. Often, in addition, the capital structure of the corporations would be so constituted that dividends were funnelled to the family and not the charity.

The third area of significant concern was charities that were engaged in carrying on non-taxable businesses in competition with taxable ones.

The approach taken in the 1975 *Green Paper* was both simple and reasonably effective. New categories of charities were established, new disbursement rules introduced, and the concept of "related business" developed. Significantly, charities were required for the first time to file an annual public information return.⁶⁴

The basic policy underlying the first two measures was that an operating charity that mainly devotes its resources to charitable activities carried on by itself should be subject to significantly less control than other types of charities. It was expected that most charities would be within this category, that is, would be *charitable organizations*. The preferential treatment was accorded because "the very nature of direct charitable activity precludes many of the abuses

⁶²*ITA, supra*, note 17 at s. 149(2) (later am. S.C. 1976-77, c. 4, s. 59(5)).

⁶³The tax liability arising on the taxpayer's death would be reduced, either because his or her stock was watered down or because the taxpayer held few shares immediately before death.

⁶⁴*ITA, supra*, note 24 at s. 149.1(14) (later am. S.C. 1984, c. 45, s. 57(16)).

of most concern to the government.⁶⁵ A charitable organization was defined, like the old category of charitable organization, to include charities that devote all their resources in a year to charitable activities carried on by themselves.⁶⁶ However, a provision was also enacted so that a charity would be considered to be devoting all of its resources to charitable activities carried on by itself to the extent that, in any taxation year, it disbursed not more than 50 percent of its income for that year to qualified donees⁶⁷ (which are mainly other charities⁶⁸). The only disbursement rule to apply to charitable organizations was that a charitable organization had to expend, in a year, an amount at least equal to 80 percent of the total of receipts for tax-deductible donations it issued in the preceding year on charitable activities carried on by itself and by way of gifts made to qualified donees.⁶⁹ It was hoped that the 80 percent rule would put a cap on fund-raising costs.

The other new category of charity that was introduced was that of the *charitable foundation*. The foundation category was itself further subdivided, into *public* foundations and *private* foundations. A public foundation was defined as a foundation where more than 50 percent of the directors or trustees deal with each other at arm's length, and of which not more than 75 percent of the capital has been contributed by one person or by a group of persons not dealing at arm's length.⁷⁰ A private foundation was defined as a foundation that is not a public foundation.⁷¹

A public foundation was required to pay out, in a year, an amount that was the greater of 80 percent of receipted gifts for the

⁶⁵*The Tax Treatment of Charities, supra*, note 2 at 7.

⁶⁶*ITA, supra*, note 24 at s. 149.1(1)(b) (later am. by S.C. 1984, c. 45, ss 57(1)-(6)).

⁶⁷*Ibid.* at s. 149.1(6)(b).

⁶⁸*Ibid.* at s. 149.1(1)(h).

⁶⁹*Ibid.* at s. 149.1(2)(b) (later am. S.C. 1984, c. 45, s. 57(8)).

⁷⁰*Ibid.* at s. 149.1(1)(g) (later am. S.C. 1984, c. 45, ss 57(1)-(6)).

⁷¹*Ibid.* at s. 149.1(1)(f).

previous taxation year and 90 percent of its income for the year.⁷² The disbursement rules for private foundations were more stringent. The basic rule of 90 percent of income was the same as the one for public foundations. A special rule, however, was introduced to deal with low-income-yielding, non-arm's-length investments. A private foundation was required to disburse the greater of 90 percent of income in a year from its investments, other than qualified investments, and 5 percent of their fair market value.⁷³ Qualified investments were generally defined as those investments that deferred income plans were eligible to make.⁷⁴ Hence, non-arm's-length investments by private foundations would be caught by the 5 percent pay-out rule,⁷⁵ which was the minimum disbursement in a year that the government deemed acceptable in exchange for the tax concessions granted to the private foundations and their contributors.

As has already been mentioned, the 1975 reforms also prohibited charities from carrying on businesses other than related businesses.⁷⁶

C. *The 1981 MacEachen Budget: The Private Foundations*

The 1981 budget of Mr. MacEachen introduced the first major changes to the tax provisions dealing with charities since the 1975 reforms were enacted.⁷⁷ The budget contained two anti-avoidance measures designed to prevent charities from circumventing

⁷²*Ibid.* at s. 149.1(3)(b) (later am. S.C. 1984, c. 45, s. 57(9)). It is effectively 90 percent of the previous year's income because of the reserve provisions in *ITA*, s. 149.1(18) (rep. S.C. 1984, c. 45, s. 57(17)).

⁷³*Ibid.* at 149.1(1)(e) (later am. S.C. 1984, c. 45, ss 57(1)-(6)).

⁷⁴*Ibid.* at s. 149.1(1)(i) (rep. S.C. 1984, c. 45, ss 57(1)-(6)).

⁷⁵It is noteworthy that the 80-percent-of-receipted-donations rule did not apply to private foundations, presumably because they were not expected to have fund-raising costs.

⁷⁶See *infra*, text accompanying note 149.

⁷⁷Legislation was introduced in 1976 and was generally applicable for 1977 *et seq.*

the disbursement rules.⁷⁸ It also included two proposals that reflected a fundamental change in government policy pertaining to the disbursement requirements of charitable foundations. The first proposal related only to private foundations. It provided that the minimum pay-out requirement of private foundations in respect of non-qualified investments be raised from 5 percent of their fair market value to 10 percent.⁷⁹ The second proposal related to both private and public foundations. Taxable capital gains were to be included, for the first time, in the calculation of income for the purposes of the 90 percent disbursement requirement.⁸⁰

The combined effect of the proposed changes on private foundations would have been profound. The operation of the 10 percent pay-out rule and the changed 90-percent-of-income rule would undoubtedly have undermined the long-term viability of many private foundations.⁸¹ The provisions would have effectively limited the 'lifetimes' of many private foundations with non-arm's-length investments to about forty years. The result possibly could have been a reduction in charitable donations by those individuals who, before the changes, would have established and contributed to private foundations.⁸²

⁷⁸*Supra*, note 43 at ss 138(a)-(b).

⁷⁹*Ibid.* at s. 138(d).

⁸⁰*Ibid.* at s. 139(b).

⁸¹See C.A. Bond, "Income Taxation of Charities: The 1983 Discussion Paper and Draft Legislation - Implications for Charitable Foundations" in *Proceedings of the 35th Tax Conference - 1983* (Toronto: Canadian Tax Foundation, 1984) 386.

⁸²But see Subcommittee on Oversight of the Committee on Ways and Means, U.S. House of Representatives, *Report and Recommendations concerning Federal Tax Rules Governing Private Foundations* (Washington: U.S. Govt. Printing Office, 1983) at 43-45; and *ibid.*, *Development of the Law and Continuing Legal Issues in the Tax Treatment of Private Foundations* (Washington: U.S. Govt. Printing Office, 1983) at 54-55. The *Tax Reform Act of 1969* introduced strict rules dealing with the U.S. equivalent to Canadian private foundations. It was found that U.S. private foundations continued to increase in number and financial strength, but the rate of growth in numbers was substantially less than the rate for the ten-year period preceding the *Act*. The U.S. pay-out requirement under the 1969 amendments was the higher of the minimum investment return and net investment income. The minimum return rate was 6 percent of assets of 1970 and adjusted by Treasury to reflect changes in money rates and investment yields.

The proposed changes met with general hostility from the foundations and their representatives. On the one hand, the benefits that had been derived by some taxpayers from the establishment of private foundations with substantial subsidies from the fisc were considerable. The estate-planning advantages have already been mentioned. It was also possible to control the operations and orientation of the foundation during the taxpayer's lifetime — as a kind of incorporated, tax-sheltered chequebook. Finally, the combined control of the taxpayer's businesses and his or her foundation raised the possibility of transactions more advantageous to the taxpayer and the taxpayer's business interests than to charity. The new pay-out requirement would have limited the estate-planning possibilities and potential conflicts of interest. Also, the public's contribution (in the form of tax concessions) to the taxpayer's private charity would, along with his or her own funds, be disbursed promptly. On the other hand, the long-term programs of private foundations would be jeopardized.

The proposals in the 12 November 1981 budget possibly also reflected the view that private foundations were not as worthy of government support as other types of charities. This belief is based on the fact that private foundations are generally elite institutions that lack the legitimacy of other types of charities because they are not funded or controlled by the public at large. However, this view ignores the reality that philanthropy as a whole is neither funded by nor controlled by the public at large.⁸³ Furthermore, even when a charity has wide financial support it is not necessarily controlled by the public or the community or some group representing a majoritarian viewpoint. In any case, it is not clear that the public interest is better served by charities governed by committee or

⁸³People who run charities are generally of a higher socio-economic status than the people who receive the charities' largess. See also Deeg, *supra*, note 9. A national sample survey on giving behaviour and attitudes was conducted for the Filer Commission by the Survey Research Centre of the Institute for Social Research at the University of Michigan. It found, among other things, that 21 percent of money contributions by individuals was projected to come from those with incomes of \$50,000 or more.

susceptible to public opinion. 'Private' charity, it has often been argued, has the potential, sometimes demonstrated, more often not, to develop creative and innovative solutions to society's problems.⁸⁴

The attitude that private foundations lack the legitimacy of other charities⁸⁵ may be the rationale for a number of provisions in the United States *Internal Revenue Code* that treat private foundations differently and less generously than other charities.⁸⁶ In Canada, government has been, except for the November 1981 budget, more favourable to private foundations. The 1976 reforms were the minimum possible in the light of the abuses. The 1981 proposal of a 10 percent pay-out for non-arm's-length investments was subsequently withdrawn and effectively replaced with a lower prescribed rate. Moreover, in 1986, the *Income Tax Act* was amended to permit a special election in respect of all capital property contributed to a charity, including intangibles such as the shares of a corporation.⁸⁷ This change is particularly significant for taxpayers who want to establish private foundations that will hold their businesses. Formerly, the election was allowed only in respect of tangible capital property that could reasonably be regarded as being suitable for use by the charity directly in carrying on its charitable activities.⁸⁸ The election permits the donor to elect

⁸⁴The comments of the Peterson Committee (The Commission on Foundations and Private Philanthropy) were as follows: "While the public rhetoric of foundations stresses continuing bold, venturesome leaps into the future, a more complete picture would include a rather pervasive passivity, and sluggishness that marks not only their financial investments and pay-out to charity but also the quality of grant making of most American foundations." *Foundations, Private Giving, Public Policy* (Chicago: University of Chicago Press, 1970) at 119.

⁸⁵But cf. B.I. Bittker, "Should Foundations be Third-Class Charities?" *The Future of Foundations*, F.F. Heimann, ed. (Englewood Cliffs, N.J.: Prentice-Hall, 1973).

⁸⁶Thus, for example, the limit on the percentage of income that can be donated in a year to a charity is lower for private foundations than for other types of charities. The rules for donations of appreciated property are somewhat less generous for donations to private foundations. There is a special excise tax of 2 percent on the investment income of private foundations. Private foundations are not permitted to own more than 20 percent of the shares of a corporation. Like Canadian private foundations, there are special pay-out rules and rules with respect to self-dealing.

⁸⁷*ITA*, *supra*, note 34 at s. 110(2.2).

⁸⁸*ITA*, *supra*, note 33 at s. 110(2.2).

between the property's fair market value and its adjusted cost base to determine the proceeds of disposition and the amount of the donor's gift. The advantage of the election is that it permits the taxpayer to obtain the highest amount possible as a charitable donation consistent with the income limitation rule, while realizing the minimum possible capital gains.

D. The 21 April 1982 Press Release: Reconsideration

The hostile reaction to the charities proposals in the 1981 budget caused the government to reconsider its position. After consultation with representatives of the foundations, the Minister of Finance issued a press release on 21 April 1982, in which he outlined a new set of proposals. The most important changes, which represented considerable back-peddling by the Department of Finance, concerned the minimum disbursement rules. First, the existing disbursement rules for both private and public foundations were replaced with a minimum disbursement quota of 4.5 percent of the market value of all investment assets. This eliminated two 'problems'. Foundations with greatly appreciated assets would not be faced, on their realization, with a massive pay-out requirement. In addition, it would no longer be necessary for foundations to attempt to calculate their income. The business concept of income had not translated particularly well to the charitable sector, often making the calculation of income for the purposes of the disbursement rules uncertain. On the other hand, the reduction in the disbursement requirements was a significant deviation from the policy of requiring a faster pay-out by foundations.

The second major change in the disbursement rules was an indirect one. In lieu of the 10 percent disbursement requirement for private foundations, a rule was introduced that the non-qualified investments of private foundations had to earn a minimum rate of return, related to the prescribed rate. If the minimum rate of return was not earned, a penalty was exacted, not on the foundation, but on the benefiting person. This approach was preferable to the all-or-nothing approach of the previous legislation, in which non-compliance with the disbursement rules resulted in deregistration of

the charity and a 100 percent tax on the charity's assets.⁸⁹ Furthermore, the new rule penalized the person who profited,⁹⁰ and not the potential donees of the charity.

In October 1982, the new Minister of Finance, Marc Lalonde, announced a delay in the implementation of the new proposals in order to give his officials time to examine the possibility of applying the same rules to both charitable foundations and charitable organizations. In May of the next year, he released the 1983 *Discussion Paper* on charities.

E. *The 1983 Discussion Paper: Plugging the Loopholes*

The epithet for the 1983 *Discussion Paper* could be Winston Churchill's admonition to the British Parliament: "We must beware of needless innovation, especially when guided by logic." The amazing thing about the 1983 *Discussion Paper* was that it proposed complex legislation relating to the charitable sector at about the same time that the government made a public commitment to the simplification of the tax provisions relating to small business.⁹¹ The complexity arose mainly from the proposed anti-avoidance rules; the disbursement rules; and the application of those rules to all charities, whether they were charitable organizations or charitable foundations.

The anti-avoidance rules were designed to prevent charities from circumventing the disbursement rules by transferring funds to *related charities*. The main problem was with the definition of related charities.⁹² Charities were deemed to be related if they had a major donor in common or if one charity was the major donor of

⁸⁹ *ITA, supra*, note 24 at ss 149.1(2)(b), (3)(b) (later am. S.C. 1984, c. 45, ss 57(8)-(9)), and 149.1(4)(b).

⁹⁰ The person who profited would be the corporation whose shares the charity held, or the person to whom it lent funds.

⁹¹ Most of the major simplifying changes to the small business provisions were enacted by *ITA, supra*, note 43 at s. 40.

⁹² The proposed legislation is found in *Charities and the Canadian Tax System, supra*, note 3 at 23-34 [hereinafter PL].

the other. A major donor was defined to include any person or group who contributed to a charity specified gifts⁹³ that constituted more than 10 percent of all gifts received by the charity after 31 December 1982 and before receipt of the gift.⁹⁴

In order for two charities to determine whether they were related, they would have to analyze and compare their record of contributors. Moreover, they would have to keep running totals of the specified gifts made not only by individuals, but also by various combinations of related individuals. The difficulties would include, for example, the possibility of siblings and spouses having different surnames, and the wish of some donors to remain anonymous. Even if the charities could get over the initial hurdle, the Minister of National Revenue was given considerable discretion to direct that charities be considered related.⁹⁵ To sum up, the rules represented an unrealistic expectation of the financial and technical sophistication of many charities.

The disbursement rules were also complex. Part of the complexity arose because of the inevitable transitional rules,⁹⁶ which accompany every major change in legislation. One rule in particular, however, dealing with loans made and received by charities, potentially raised a lot of compliance problems.⁹⁷ It required that charities operate in exactly the opposite way from how they had under the previous legislation. Under the previous legislation, there was no disbursement requirement for any loan a charity received. As a corollary, a loan made by a charity did not count toward the fulfilment of its disbursement quota. The new legislation would have required loans received to be treated as gifts (income) and loans made to be treated as charitable disbursements.

⁹³A specified gift was defined as a gift with a fair market value at the time of its donation of not less than \$1,000. PL, *ibid.* at s. 149.1(1)(g).

⁹⁴*Ibid.* at s. 149.1(1)(b).

⁹⁵*Ibid.* at ss 149.1(4)(5).

⁹⁶*Ibid.* at s. 188(1)(b)(v)

⁹⁷*Ibid.* at ss 188(1)(v)(ii) and (d)(iii).

The problem of the complexity of the rules was exacerbated because they applied not only to foundations but also to charitable organizations. Even more than the foundations, the charitable organizations (especially the smaller ones) did not have the resources to comply with the new rules.

The proposed legislation in the 1983 *Discussion Paper* provoked another outcry from the charitable sector. This time the complaints came mainly from charitable organizations, rather than the foundations. In the end, the government's response was not to enact most of the complex rules proposed in the *Discussion Paper*.

Instead, proposals were introduced in the Minister of Finance's Economic Statement of 8 November 1984, to make more limited changes in the charities legislation.

F. *The Economic Statement of 8 November 1984: Retrenchment*

The legislation introduced in 1984 made a number of important changes to the 1975 reform legislation. The legislation had two aspects. First, it incorporated the proposals announced in the 8 April 1982 press release, which represented a withdrawal from the tougher disbursement rules contained in the 12 November 1981 budget. Hence, the general disbursement requirement for foundations was reduced from 5.5 percent to 4.5 percent.⁹⁸ In addition, the 90-percent-of-income rule was dropped. Finally, a rule was introduced to provide that where the non-qualified investments of a private foundation do not earn a prescribed minimum rate of return, not the charity, but the person who profited (that is, the borrower or corporation whose shares the foundation holds) is subject to a 100 percent tax on the shortfall.⁹⁹

The second aspect of the 8 November legislation was the introduction of new anti-avoidance rules. The rules were quite simple and generally limited to foundations. Basically, they provided

⁹⁸The minimum rate was not actually 5 percent since the formula was the lesser of 5 percent of the fair market value of the assets and 90 percent of income; that is, 5.5 percent.

⁹⁹*ITA*, *supra*, note 43, s. 78 at s. 189. [*Ed.*: Section 78 is the amending section; s. 189 is the *ITA* section referred to.]

that at least 80 percent (or 100 percent, in the case of a private foundation) of gifts received by a foundation from other charities must be paid out in its next taxation year.¹⁰⁰ In addition, a special tax of 25 percent was imposed on a foundation that transfers more than 50 percent of its capital to a charitable organization for the purpose of reducing or postponing its disbursement requirements.¹⁰¹ Although not necessarily an anti-avoidance rule, the new requirement that charitable organizations have an independent board of directors¹⁰² obviously is helpful in limiting abuses.

The third aspect of the 8 November legislation was the preservation of the distinctions between charitable organizations and charitable foundations. The disbursement requirement of charitable organizations was to remain at 80 percent of receipted donations.¹⁰³

G. Charities and Political Activities

In 1985, legislation was introduced to permit registered charities to engage in political activities in certain circumstances. A registered charity is permitted to devote resources to political activities if, in the case of charitable organization, it devotes substantially all its resources to charitable activities carried on by itself or, in the case of a charitable foundation, it devotes substantially all its resources to charitable purposes. In addition, the political activities must be *ancillary and incidental* to its charitable activities or purposes.¹⁰⁴ The resources that may be expended on political activities are limited, because expenditures on political

¹⁰⁰*Ibid.* s. 57 at ss 149.1(1)(e)(ii)-(iii).

¹⁰¹*Ibid.*, s. 78 at s. 188(3).

¹⁰²*Ibid.*, s. 57 at s. 149.1(1)(b)(iii) (more than 50 percent of the directors or trustees deal at arm's length).

¹⁰³It was proposed in the *Discussion Paper* that the pay-out for all charities be 80 percent of all gifts. PL, *supra*, note 92, s. 188(1)(b)(iii). This would have left the smaller charitable organizations without much manoeuvring room.

¹⁰⁴*ITA*, *supra*, note 34, s. 85(2) at ss 149.1(6.1)-(6.2).

activities cannot be counted towards the fulfilment of a charity's disbursement requirements.¹⁰⁵

It is a moot point whether, in fact, the legislation was even necessary. Under the common law, a charitable purpose can include ancillary and incidental political objects.¹⁰⁶ On the other hand, the tax provisions dealing with charities required that a charitable organization devote all its resources to charitable activities¹⁰⁷ and that a charitable foundation be constituted and operated exclusively for charitable purposes.¹⁰⁸ On a fair and liberal interpretation of the provisions, it is arguable that resources devoted to ancillary and incidental political activities are in fact resources devoted to the charity's activities or purposes.

Whatever the merits of the argument, it has been Revenue Canada's position since at least 1978 (and probably earlier) that, until the amendment, the *Income Tax Act* prohibited charities from engaging in any political activities. The significance of 1978 is that Revenue Canada issued *Information Circular 78-3*, which promulgated its view in that year.¹⁰⁹ The public's response, however, was sufficiently adverse that the Department had to withdraw the circular. Nonetheless, no change was forthcoming in Revenue Canada's administration of the income tax provisions. Subsequently, in 1980, it refused to register a charity on the basis that it had a political rather than a charitable purpose, and in 1981 it attempted

¹⁰⁵ *Ibid.*, s. 85(1) at s. 149.1(1.1)(b).

¹⁰⁶ L.A. Sheridan, "Charitable Causes, Political Causes and Involvement" (1980) 2:4 *Philanthrop.* at 5.

¹⁰⁷ *ITA*, *supra*, note 24 at s. 149.1(1)(b) (later am. S.C. 1984, c. 45, ss 57(1)-(6)). The same formulation is currently found in s. 149.1(1)(b)(i) but it is modified by *ITA* s. 149.1(6.2).

¹⁰⁸ *ITA*, *ibid.* at 149.1(1)(a). Currently s. 149.1(1)(a) is modified by *ITA* s. 149.1(6.1).

¹⁰⁹ Canada, Department of National Revenue, Taxation, *Information Circular No. 78-3, Registered Charities: Political Objects and Activities* (February 27, 1978). Some very limited political activities were permitted. They included presenting briefs with recommendations to appropriate government bodies, whether or not solicited (provided they were not part of a campaign to influence legislation), and making representations to elected representatives or government officials. However, lobbying, public demonstrations, and writing letters to editors of newspapers that air political views or attempt to sway public opinion on a 'political' issue were prohibited.

to revoke the registration of a charity on the ground that it engaged in political activities.

The first case involved the Department's refusal to register the Manitoba Foundation for Canadian Studies as a charity. The main object of the foundation was to publish *Canadian Dimension*. The magazine specialized in economic issues, and its approach could be characterized as left of centre. Revenue Canada's position was that the magazine's main goal was not to educate, but to promote a particular ideology.¹¹⁰

The second case involved the deregistration of Renaissance International, an Ontario-based evangelical organization. Renaissance had purchased two full-page advertisements in a newspaper urging voters to elect a "moral majority" in the federal election. The advertisements also asked readers to express their concern about pro-homosexual candidates in the Toronto civic race. In addition, Renaissance groups across the country apparently prepared and publicized moral report cards on candidates in elections.¹¹¹ Ultimately, the case was argued before the Federal Court, not on the basis of whether the activities were permissible, but on a denial of natural justice by Revenue Canada.¹¹²

At least one commentator¹¹³ has suggested that the actions of Revenue Canada in the Renaissance case and in the *Canadian Dimension* case did not provoke nearly the outcry from the general public as did its publication of the 1978 information circular. Perhaps the reality of taxpayer-subsidized charities engaging in controversial activities was less palatable, and the need for limits more obvious.

In any case, as already indicated, legislation was introduced in 1985 to permit charities to engage in limited political activities. In evaluating the legislation, two things have to be kept in mind.

¹¹⁰G. Pitts, "Charities fight for right to lobby," *The Financial Post* (16 May 1981) 1.

¹¹¹A. Drache, "Revenue's arbitrary rulings get whacked by court" *The Financial Post* (4 December 1982) 1.

¹¹²*Renaissance International v. MNR*, [1982] C.T.C. 393 (F.C.A.).

¹¹³N. Brooks, *Charities: the Legal Framework* (Ottawa: Secretary of State, 1983).

First, the problem of charities engaging in political activities is intractable, perhaps unsolvable. It is arguable that all acts or failures to act are political acts, and that it is impossible to separate morals and politics. Second, the problem of charities engaging in political activities may be more theoretical than practical. Registered charities have the option of circumventing limitations on their political activities simply by incorporating non-charitable entities to carry on their political activities for them.¹¹⁴

Before considering the policy underlying the 1985 legislation, mention should be made of possible constitutional impediments. It is possible, if not probable, that the limitations on political activities incorporated in the *Income Tax Act* will be challenged successfully under the *Canadian Charter of Rights and Freedoms*.¹¹⁵ The basis would be either the freedom of speech provision in section 2 of the equality rights provision in section 15. A U.S. case, *Taxation with Representation of Washington v. United States*¹¹⁶ provides some indication of the arguments that might be made under the *Charter*.

In *Taxation with Representation of Washington* (TRW) a suit was brought by a non-profit organization seeking a declaratory judgment that it qualified for tax-exempt status under section 501(c)(3) of the *Internal Revenue Code of 1954*. Section 501(c)(3) grants tax exemption to certain non-profit organizations, "no substantial part of the activities of which is carrying on propaganda, or otherwise attempting to influence legislation." Another section of the *Code*, 170(c)(2), permits taxpayers who contribute to section 501(c)(3) organizations to deduct the amount of their contributions on their federal income tax. *TRW*, which was organized to promote its view of the public interest in the area of taxation, had been denied registration as a section 501(c)(3) organization because it appeared that a substantial part of its activities would consist of attempting to influence legislation.

¹¹⁴This might be difficult for some charities, such as religious organizations.

¹¹⁵*Canadian Charter of Rights and Freedoms*, Part I of the *Constitution Act, 1982*, being Schedule B of the *Canada Act 1982* (U.K.), 1982, c. 11 [hereinafter *Charter*].

¹¹⁶(1983), 103 S. Ct. 1997.

TRW claimed the prohibition against substantial lobbying was unconstitutional on two grounds. First, it violated the First Amendment (freedom of speech) because it imposed an "unconstitutional burden" on the recipient of tax-deductible contributions. Second, the prohibition was unconstitutional under the equal protection component of the Fifth Amendment due process clause because the *Code* permitted tax-deductible contributions to veterans' organizations, which are permitted to lobby the government.

The Supreme Court of the United States, all concurring, held that the prohibition was constitutional. The opinion of the Court was delivered by Mr. Justice Rehnquist who said:

TWR is certainly correct when it states that we have held that the government may not deny a benefit to a person because he exercises a constitutional right [freedom of speech].... But *TWR* is just as certainly incorrect when it claims that this case fits the *Speiser-Perry* model. The Code does not deny *TWR* the right to receive deductible contributions to support its non-lobbying activity, nor does it deny *TWR* any independent benefit on account of its intention to lobby. *Congress has merely refused to pay for the lobbying out of public moneys.*¹¹⁷

Mr. Justice Rehnquist also stated that there was no infringement of Fifth Amendment rights. He indicated that the distinction drawn between section 501(c)(3) organizations and veterans' organizations was valid since it bore "a rational relationship to a legitimate governmental purpose."¹¹⁸ He also noted that "legislatures have especially broad latitude in creating classifications and distinctions in tax statutes."¹¹⁹

A *Charter* challenge to the limitations on the political activities of charities based on freedom of speech is likely to reproduce the First Amendment arguments used by *TRW*. On the other hand, the arguments advanced by *TRW* in respect of its Fifth Amendment rights do not necessarily transfer well or, indeed, at all to the Canadian *Charter*. First, the Canadian equality rights provision is worded differently than the U.S. one. Section 15 of the

¹¹⁷ *Ibid.* at 2001 [emphasis added].

¹¹⁸ *Ibid.*

¹¹⁹ *Ibid.* at 2002.

Charter provides equality rights to *individuals*.¹²⁰ Hence, it may be that charities, whether trusts, corporations, or unincorporated organizations, are not covered by section 15. It may be possible, however, to formulate an equality rights argument for the contributors to a charity, rather than the charity itself. Second, even assuming the individual limitation is surmountable, there really is no organization comparable to charities, such as the U.S. veterans' organizations, under Canadian tax legislation. Thus, an equality rights argument might have to rest on comparison of charities and, for example, corporations. To the extent that the comparison is not between very similar entities, it can be expected that it will be easier for the fisc to argue that the difference in tax treatment is well founded.

Constitutional considerations aside, there are a number of good reasons why charities should be able to carry on whatever political activities they want. The nomenclature at this point, however, becomes confusing because if charities are permitted to carry on unlimited political activities, they cease to be charities under the common law. Hence, the real issue is whether the tax concessions that are now extended to charities should be extended to other non-profit organizations in the voluntary sector.

Certainly, the years since World War II have witnessed in Canada some fundamental changes in the voluntary sector. In the first place, the care of the needy and the ill, which was once the primary focus of private charity, is now largely handled by government.¹²¹ New issues have assumed prominence, such as the environment and native and women's rights. Increasingly, volunteer organizations see one of their important roles to be government watchdogs and advocates of social and legislative reform. They view themselves as important participants in the modelling of a pluralistic Canadian society. Even the traditional charities dealing with, for example, the problems of poverty, imprisonment, and the aged, are taking on a more political role based on their understanding that real solutions are fundamentally political.

¹²⁰ *Charter*, *supra*, note 115.

¹²¹ S.A. Martin, *Financing Humanistic Service* (Toronto: McClelland and Stewart, 1975) at 23ff.

Many of the justifications for the special tax status of charities can also be made for these new-style charities and voluntary organizations. Most important, they are a counterbalance to the government. In addition, they sometimes assume a similar role *vis-à-vis* business. Tax concessions to such organizations may then offset the ability of business to write off the costs of many of their political activities as a cost of carrying on business.¹²²

On the other hand, there are some compelling reasons for restricting the ability to issue receipts for tax-deductible contributions to charities that carry on only limited political activities. First, the traditional justification for tax concessions to charities — that they do things that otherwise the government would have to do — does not apply to non-profit organizations whose primary thrust is political. Second, there is unlikely to be the same societal consensus in favour of extending the concession to other non-profit organizations that are essentially political in nature. The public may support tax concessions for the old-style, generally non-controversial charities. They are not likely, however, to support tax concessions for charities that may be involved in political activities perceived to be threatening, divisive, and destabilizing. Of course, even within the limits laid down in the 1985 legislation, there is the risk of alienating the public.

If the policy of permitting charities to engage in limited political activities is an appropriate compromise between those who would have them carry on no political activities and those who would permit unlimited activities, the execution of the policy in the legislation is flawed. First, if one assumes that charities should be able to carry on limited political activities, then the present system of permitting charities to use only those resources left after they fulfil their disbursement requirements is unfair. Charitable organizations will be at a disadvantage because they are the charities least likely to have funds in reserve. Charitable organizations are also the charities that are 'in the field' and to whom it is arguably most important to give a political voice. A system similar to the one in the United States might be better. The legislation could provide,

¹²² On the other hand, perhaps a better equilibrium would be achieved by limiting the ability of business to write off political expenses.

for example, for a charity to be permitted to expend on a percentage (on a sliding scale) of the amount it disbursed on charity in the year on political activities.¹²³ One problem with the sliding scale, however, is that provisions would have to be introduced to prevent charities from splitting into two or more units in order to increase their allowable expenditures on political activities.

A second criticism of the execution of the policy is not with the legislation, but with Revenue Canada's interpretation of the requirement that the charity has to devote "substantially all" of its resources to charitable activities carried on by itself, or to charitable purposes. Revenue Canada's position as stated in *Information Circular 87-1* is that "substantially all" means 90 percent or more. A preferable approach is the one adopted by the U.S. Court of Appeals for the Tenth Circuit in *Christian Echoes National Ministry, Inc. v. United States*.¹²⁴ In that case, the court explicitly rejected a percentage test in determining "substantially", as obscuring the "complexity of balancing the organization's activities in relation to its objectives and circumstances." It further stated: "The political (that is, legislative) activities of an organization must be balanced in the context of the objectives and circumstances of the organization to determine whether a *substantial* part of its activities was to influence or attempt to influence legislation."¹²⁵

A final criticism of the 1984 amendments is that no distinction is made between permissible political activities of private foundations, and those of charitable organizations and public foundations. In the United States, private foundations cannot engage in most political activities without penalties. It is arguable that the same position should obtain in Canada. The concern here

¹²³In the United States a charity is allowed to expend 20 percent of the first \$500,000 of its expenditures for an exempt purpose, plus 15 percent of the next \$500,000 on "legislative lobbying", 10 percent of the next \$500,000, and 5 percent of any remaining expenditures. However, the total amount spent for legislative activities in any one year by a charity may not exceed \$1,000,000. A further amount, namely one-fourth of the foregoing amounts, may be expended by a charity on attempts to influence the general public on legislative matters (grassroots lobbying).

¹²⁴(1972), 470 F.2d 849.

¹²⁵*Ibid.* at 855.

is that a private foundation could become a vehicle for the expression and dissemination of the political views of a particular individual or family. The individual or family would therefore enjoy a direct benefit, as a result of their philanthropic activities, that is contrary to the spirit of the regime of tax concessions granted to them. If private foundations are permitted to carry on political activities, there may also be adverse social and political implications.

IV. PRESENT PROBLEMS

Part III indicated a number of problem areas in which the government has attempted, and sometimes succeeded in making, reforms. This paper has already indicated several areas that may ultimately merit further consideration. The new disbursement rules, especially for private foundations, may not generate large enough pay-outs to justify the tax concessions and other advantages given to them and their contributors. It is not yet clear whether the new anti-avoidance rules will accomplish their purpose. The right balance may or may not have been struck by the new rules on the political activities of charities. Indeed, suggestions on how the political activities provisions might be improved have been given. Nevertheless, it would seem appropriate that, for the time being, the charities area be left alone in order to see how the legislation works in practice.

Reforms aside, there are four areas that probably deserve separate consideration as present issues, if not as present problems. The first issue is, of course, the new lower tax rates that will be proposed in the Hon. Mr. Michael Wilson's tax reform. Lowered tax rates will inevitably reduce the incentive to taxpayers to make charitable donations. It is not clear what response, if any, the government will have. The other issues or problems are the definition of charity, the choice between tax deductions and tax credits, and the scope of the related business provisions. These issues are worth considering because recent history has not ruled out possible changes.

A. *The Definition of Charity*

The *Income Tax Act* defines a "charity" as a "charitable organization" or a "charitable foundation."¹²⁶ A charitable organization is defined as an organization carrying on "charitable activities",¹²⁷ and a charitable foundation is defined as a corporation or trust carrying on "charitable purposes."¹²⁸ No meaning, however, is given in the *Act* to charitable activities or purposes. Thus, ultimately, the definition in the *Act* of the term charity depends on the common law.

There are countless cases in the United Kingdom and Canada that deal with the question of what is a charity or a charitable purpose.¹²⁹ The leading case on the meaning of charity is *Commissioners for Special Purposes of Income Tax v. Pemsel*.¹³⁰ In that case, Lord Macnaughten, who wrote the leading majority opinion, said: "Charity' in its legal sense comprises four principal divisions: trusts for the relief of poverty; trusts for the advancement of education; trusts for advancement of religion; and trusts for other purposes beneficial to the community, not falling under any of the preceding heads."¹³¹ Generally speaking, for a purpose to be found to be charitable, it must be within one of the four categories listed

¹²⁶*ITA*, *supra*, note 17 at s. 149.1(1)(d).

¹²⁷*Ibid.* at s. 149.1(1)(b)(i).

¹²⁸*Ibid.* at s. 149.1(1)(a).

¹²⁹Only a handful, however, deal with the meaning of charity for tax purposes. In most of the cases the issue is whether a trust (often established by a will) is for a charitable purpose. If it is, the trust will be valid even if its terms violate the rule against perpetuities or are uncertain. If it is not, the next of kin of the testator may have grounds to attack the will.

¹³⁰[1891] A.C. 531.

¹³¹*Ibid.* at 583.

by Lord Macnaughten.¹³² The purpose must also be for the public benefit. Public benefit means that the purpose must fulfil some social interest, and the 'public' or some significant subcommunity, not a small number of persons, must be served.¹³³ In addition, the purpose cannot be against public policy. This includes, for example, a substantial political element¹³⁴ or connection with non-charitable purposes such as personal profit-making. Finally, the purpose should be within the "spirit and intendment" of the preamble to *An Act to redress the Mis-employment of Lands, Goods and Stocks of Money heretofore given to certain charitable Uses*.¹³⁵

Two questions arise from the common law meaning of charity. The first is: should the meaning of charity be expanded or contracted for the purposes of determining eligibility for the tax

¹³²But see *Scottish Burial Reform and Cremation Society v. Glasgow Corporation* (1967), [1968] A.C. 138 at 154, [1967] 3 All E.R. 215 at 223, in which Lord Wilberforce said:

But three things may be said about it, which its author would surely not have denied: first that, since it is a classification of convenience, there may well be purposes which do not fit neatly into one or the other of the headings; second, that the words used must not be given the force of a statute to be construed; and thirdly, that the law of charity is a moving subject which may well have evolved even since 1891.

¹³³If the purpose is to be found within the first three of Macnaughton's categories, the presumption is that the purpose is for the public benefit. If the purpose is within the fourth category, the burden generally falls on the proponent to prove the purpose is for the public benefit. This analysis was presented in considerable detail in Brooks, *supra*, note 113.

¹³⁴Sheridan, *supra*, note 106.

¹³⁵(U.K.) 43 Eliz., c. 4; *Morice v. Bishop of Durham* (1805), 10 Ves. Jun. 522, 32 E.R. 947.

The statute is long since repealed but its list of charitable purposes is still referred to. It included:

- the relief of aged, impotent and poor people;
- the maintenance of sick and maimed soldiers and mariners;
- the maintenance of schools of learning, free schools and scholars in universities;
- the repair of bridges, ports, havens, causeways, churches, sea-banks and highways;
- the education and preferment of orphans;
- the relief, stock or maintenance of houses of correction;
- the marriage of poor maids;
- the supportation, aid and help of young tradesmen, handicraftsmen, and persons decayed;
- the relief and redemption of prisoners or captives;
- the aid or ease of any poor inhabitants concerning payment of fifteens, setting out of soldiers and other taxes.

concessions under the *Income Tax Act*? The second question is: how should that meaning be expressed?

In answering the first question one has to be against extending the definition of charity, in any major way, if one thinks tax concessions for charities are tax expenditures.¹³⁶ In that view the charitable exemption from tax and the tax deduction are not technical tax provisions designed to assist in the calculation of a taxpayer's taxable income. Rather, they are measures designed to achieve a specific social goal that could be achieved by other methods, such as direct grants. In general, alternative methods of delivering subsidies are to be preferred to tax expenditures.¹³⁷

Nonetheless, as suggested at the beginning of this paper, the tax concessions to charities appear to rest on societal consensus. Therefore, despite the almost total lack of control by the government of the disposition of large amounts of public funds and the upside-down nature of the subsidy (in respect of the charitable deduction), the charitable deduction or some variation is likely to be retained for the foreseeable future. On the other hand, there is little reason to extend the concessions to activities not now classified as charitable, although other forms of assistance may be appropriate.¹³⁸ The one exception, perhaps, would be some kind of tax deduction or credit for public interest groups, precisely because, among other things, absence of government control is a desirable characteristic of such a subsidy.¹³⁹

¹³⁶But *cf. supra*, text at 1.

¹³⁷See S.S. Surrey, *Pathways to Tax Reform: The Concept of Tax Expenditures* (Cambridge: Harvard University Press, 1973).

¹³⁸A typical example of the pressure on governments is the recommendation of the recent task force on the funding of the arts to include registered Canadian arts organizations as eligible recipients of tax-deductible charitable donations. The organizations do not qualify at present for charitable status because they provide a variety of services not to the public but to their constituencies, which are within the artistic community. Task Force on Funding of the Arts in Canada, *Funding of the Arts in Canada to the Year 2000* (Ottawa: Minister of Supply and Services, 1986) at 101. But *cf.* the deduction for registered Canadian amateur athletic associations in *ITA, supra*, note 17 at s. 110(1)(a)(ii).

¹³⁹The issue of funding public interest groups is beyond the ambit of this paper. See, however, K.G. Englehart & M.J. Trebilcock, *Public Participation in the Regulatory Process: The Issue of Funding*, Working Paper No. 17 (Ottawa: Economic Council of Canada, 1981).

A more extreme position is that the definition should be narrowed. The argument is that government has limited resources and that it is up to it as the elected representative of the people to allocate these resources according to some plan of priorities. To the extent that charities do what government would otherwise have to do, tax concessions to them can be justified. Otherwise, their activities, however estimable, should not be subsidized through the tax system.

The second question is: assuming the present core meaning of charity is retained, how should it be expressed? A number of bodies in England have seriously considered the problem of setting out a comprehensive and comprehensible detailed definition of charity.¹⁴⁰ The idea is that a detailed definition will be more understandable to non-lawyers than the subtle distinctions made in a myriad of sometimes conflicting cases under the common law.

On the other hand, it is not at all clear that the charities sector in Canada is clamouring for a change. A detailed definition is likely to be more inflexible and less susceptible to incremental change than the common law (which is desirable at the margins). In addition, a new definition would probably make a great deal of the previous case law obsolete. The law might, therefore, become less predictable. Finally, it is not at all certain that the 'hard cases' would be any easier to determine under detailed legislation than under the common law.

B. *Tax Deduction versus Tax Credit*

The Carter Commission's discussion of the deduction for charitable donations left much to be desired. It dismissed the idea of substituting a credit for the deduction in two sentences. The government response to the Commission's *Report*, the *White Paper* on tax reform, did not mention charities, let alone the specifics of the charitable donation. Subsequently, during the various reforms in the charities area, no government publicly acknowledged the tax

¹⁴⁰The various English reviews of the definition of charity are detailed by Brooks, *supra*, note 113.

deduction versus tax credit debate. However, the Minister of Finance, Mr. Wilson, has suggested that one aspect of his proposed tax reform will be to substitute tax credits for certain tax exemptions and deductions.

The Carter Commission referred to, but did not discuss, two key features of the tax deduction-tax credit debate. They are the equity argument, and the problem of upper-income contributors to charity. The Commission said that if equity was the only consideration then it would recommend the substitution of a tax credit for a tax deduction.¹⁴¹ It can be assumed that by "equity" the Commission meant the proposition that a charitable donation should be worth the same to all taxpayers whatever their marginal rates of tax. Under the present system of a charitable deduction, a charitable donation is worth more to a higher-income taxpayer than to a lower-income taxpayer. Thus, for example, if a taxpayer at a 50 percent marginal rate makes a \$100 donation to charity, the donation is worth \$50. On the other hand, if the taxpayer is at a 20 percent marginal rate, the \$100 donation is worth only \$20. If, perchance, the taxpayer is unfortunate enough to have no taxable income, the \$100 donation is worth nothing. In other words, the cost of the \$100 charitable donation to the three taxpayers is, respectively \$50, \$80, and \$100. Therefore, the cost of the charitable donation is the greatest to the taxpayer who presumably can least afford it.

Under a tax credit system, each of the taxpayers would receive the same amount of tax credit for the same amount of charitable contribution. The credit would be refundable to taxpayers who incurred no tax liability in the year; hence, the taxpayer with no taxable income would receive a refund equal to the value of the tax credit. In Canada, assuming the same loss in government revenues for a tax credit scheme as for the present charitable deduction under the present tax system and rates, a tax credit would be approximately 28 percent of the charitable donation.¹⁴² Hence, in the example discussed here, the taxpayers with marginal rates of 50 to 20 percent would each receive a credit against their tax liabilities of \$28. The

¹⁴¹Report, vol. 3, *supra*, note 1 at 222.

¹⁴²R.D. Hood, S.A. Martin & L.S. Osberg, "Economic Determinants of Individual Charitable Donations in Canada" (1977) 10 Can. J. Econ. 653 at 667.

taxpayer with no tax liability would receive a refund of \$28.

Notwithstanding the equity argument, the Carter Commission did not recommend the adoption of a tax credit system. The reason probably was somewhat more complicated than the one it gave in the *Report*. In its *Report*, the Commission said that a change to a credit system would tend to "stifle" giving by upper-income taxpayers.¹⁴³ It is true that the cost of a charitable donation to higher-income taxpayers would be greater under a tax credit system than under the present tax deduction. Therefore, they could be expected to make fewer donations. On the other hand, the cost of a charitable donation would go down for lower-income taxpayers, and their donations could be expected to go up. Thus, the result of substituting a credit for a deduction is not so much that total charitable donations will go down¹⁴⁴ as that the donations will be distributed differently between higher- and lower-income taxpayers.

The significance in the change of contribution patterns to charity arises from the fact that lower-income taxpayers generally do not contribute to the same types of charities as higher-income taxpayers. Lower-income taxpayers give a very high percentage of their donations to religious organizations and, to a lesser extent, to certain social welfare agencies. Higher-income taxpayers tend to give to educational and cultural charities.¹⁴⁵ Thus a change from a deduction to a credit has profound implications for the funding of education and the arts.

Given the equity-distribution conflict, the choice between the deduction and the credit is not obvious. Of course, there are those who argue that equity is important enough to override concerns about decreased funding for certain long-established institutions.¹⁴⁶

¹⁴³*Report*, vol. 3, *supra*, note 1 at 222.

¹⁴⁴It is assumed that the price elasticity of contributions at every income level is about the same.

¹⁴⁵R.M. Bird & M. Bucovetsky, *Canadian Tax Reform and Private Philanthropy* (Toronto: Canadian Tax Foundation, 1976) at 10.

¹⁴⁶N. Brooks, *Financing the Voluntary Sector: Replacing the Charitable Deduction* (Toronto: Law and Economics Workshop Series, Faculty of Law, University of Toronto, 1981).

On the other hand, there are those (including the Carter Commissioners) who feel that the continuation of funding for education and the arts is important enough to disregard the obvious inequity of the deduction. Perhaps one way that a choice can be made between the deduction and the credit is to examine how either fits in with the two or three most important justifications for tax concessions to charity.

The traditional justification for tax concessions to charity is that charities do what government would otherwise have to. Therefore the question is: does a tax deduction or a tax credit give more support to charities doing what government would otherwise have to do? The question cannot be answered definitely without more empirical research. However, some observations can be made. There is a spectrum of charitable activities. On one end, there are social welfare activities. The role of these charities is to try to fill in the gaps and to assist the government in providing minimum social justice. Arguably, in the words of one commentator, the government should be "totally committed to social welfare."¹⁴⁷ At the other end of the spectrum, there are religious activities in which, again arguably, the government should be totally uninvolved. In the middle, education leans towards the social welfare end, and arts and culture towards the religious end. On balance, one would think that the current charitable deduction gives more support to charities that do what government would otherwise have to do.

There is considerable debate, however, over the redistributive effects and uses of contributions to religious organizations. Some commentators have said that a small percentage of contributions to religious groups gets used outside the group or for social welfare purposes. On the other hand, the Interfaith Research Committee of the Filer Commission estimate that at least one-fifth of religious giving goes to non-sacramental uses.¹⁴⁸

The other commonly cited justifications — or justification, since they are linked — for tax concessions to charities is that charities are a counterbalance to government and business, that they

¹⁴⁷ *Ibid.* at 8.

¹⁴⁸ Commission of Private Philanthropy and Public Needs, *supra*, note 8 at 57.

promote the development of alternative strategies to deal with social and economic problems, and that they reinforce the underpinnings of a pluralistic society. To the extent that the credit will permit more taxpayers to participate in the charitable sector, then arguably the pluralistic society is strengthened. A counter-argument, however, is that pluralism is something more than the ability to decide what institutions in society will provide what public goods. Simply, an argument may be made that some institutions are richer contributors to the social, cultural, and intellectual mosaic than others. Hence, it may be possible to justify a system of deduction that is skewed in the direction of the favourite charities of upper-income taxpayers.

C. *The Scope of Related Business*

The history of the introduction of the related-business provisions into the *Income Tax Act* has already been given. Since then, there have been few Canadian court cases¹⁴⁹ on whether a business is a related business. The situation in Canada is in notable contrast to that in the United States, where a myriad of cases have been heard. The reason for the different experiences is not clear. Modest empirical research, however, indicates that there is considerable uncertainty in the field about the scope of related businesses and the propriety of various income-generating activities carried on by charities. It appears to be quite possible that the related-business issue will assume some importance in the foreseeable future.

V. CONCLUSION

The recommendations of the *Carter Report* on the tax treatment of charities and charitable donations are, to reiterate, more interesting for what is omitted than for what is proposed. With twenty years' hindsight, it is clear that the Commission failed to anticipate the nearly inevitable changes in the relationship

¹⁴⁹ *Alberta Institute on Mental Retardation v. The Queen*, [1987] 2 C.T.C. 70 (F.C.A.).

consummated through the tax system between the government and the voluntary sector. Thus, in contrast to most of the *Report*, the Commission's work on charities and charitable donations is not of continuing relevance.