



RECEIVED FEB 9 2014

Mr. Perrin Beatty
President & CEO
Canadian Chamber of Commerce
420 -360 Albert Street
Ottawa, ON K1R 7X7

Subject: Non-Profit Organization Risk Identification Project

Dear Sir,

The Canada Revenue Agency conducted the Non-Profit Organization Risk Identification Project to gather information about the current operations of organizations claiming tax-exempt status as a non-profit organization (NPO).

The Non-Profit Organization Risk Identification Project found that a significant portion of incorporated organizations selected for review did not meet all the requirements found in the *Income Tax Act*. The project also found that some organizations would benefit from more guidance about the requirements under existing legislation.

Enclosed is a report on the findings from the Non-Profit Organization Risk Identification Project. The report has been shared with the Department of Finance Canada.

NPOs provide important and valuable benefits to society. We will use the research findings to inform our ongoing efforts to engage and consult with the NPO community on how to assist them in understanding and complying with the tax laws that affect them.

In addition, the Government recently announced a consultation on NPOs as part of Economic Action Plan 2014. The Government will provide further details on this consultation in the coming months.

If you have questions about the project, you are welcome to call me at 613-946-3447.

Sincerely,

Susan Betts, CMA

Director General
Small and Medium Enterprises Directorate
Compliance Programs Branch
Canada Revenue Agency

Enclosure

Non-Profit Organization Risk Identification Project Report

The Canada Revenue Agency (CRA) is committed to supporting a strong non-profit sector. In particular, the CRA is committed to making sure all organizations in this sector have the information and tools they need to comply with the income tax laws fully and on time, and that they receive all the benefits they are entitled to receive.

Each year, the CRA conducts a number of review activities to promote compliance with the laws it administers. These reviews help to protect the integrity of the self-assessment tax system and to maintain Canadians' confidence in the fairness of the system.

One of these reviews is the Non-Profit Organization Risk Identification Project (NPORIP), which the CRA started in 2009. The NPORIP was designed to provide the CRA with insight into the way organizations claiming the exemption under paragraph 149(1)(l) of the *Income Tax Act* operate under the rules of that provision, allowing the CRA to get a better understanding of the issues these organizations face in complying with the Act and to evaluate their level of compliance with the Act.

Background

Although the terms **non-profit organization** and **not-for-profit organization** are widely used to refer to a number of different types of organizations, including registered charities and other organizations that claim an income tax exemption under subsection 149(1) of the Act, for purposes of the project, the term **non-profit organization**, or **NPO** for short, refers to an organization that meets the conditions of paragraph 149(1)(l) of the Act, that is, an organization:

- that is a club, society, or association;
- that is not a charity;
- that is both organized and operated exclusively for social welfare, civic improvement, pleasure, recreation, or any other purpose except profit; and
- the income of which is not payable to or available for the personal benefit of a proprietor, member, or shareholder.

The exemption from tax for NPOs under paragraph 149(1)(l) of the Act was first introduced in the *Income War Tax Act, 1917*. The nature of the groups eligible for the exemption has evolved significantly over the years. It now includes a wide variety of organizations, including professional associations, recreational or social organizations, organizations operated for civic improvement, multicultural organizations, and low-cost housing organizations. NPOs also range from small, unincorporated, and informal associations to large corporations involved in considerable commercial activity.

The number of NPOs in Canada is not known, but estimates suggest there may be more than 80,000.¹ NPOs do not have to register under the Act, and their filing requirements under the Act vary depending on their structure, activities, and size—with many unincorporated NPOs not having to file any tax forms at all. As a result, there is little information that the CRA can rely on to evaluate the extent of the sector's compliance with the income tax rules, or to ensure proper accountability with respect to the public resources devoted to the tax exemption (estimated at \$75 million for 2012²).

In response, the CRA started the NPORIP in 2009, focusing on organizations claiming an exemption from income tax under paragraph 149(1)(l) of the Act. Since the number of organizations is not known, the study drew a random sample from a group of 30,000 identified organizations.³ Because of the make-up of the sample, the study's findings are representative only of incorporated NPOs under paragraph 149(1)(l) of the Act.

CRA audit staff reviewed the sample organizations with reference to four key requirements set out in the Act: 1) that the organization is not a charity; 2) that the organization is **organized** exclusively for social welfare, civic improvement, pleasure, recreation, or any other purpose except profit; 3) that the organization is **operated** exclusively for social welfare, civic improvement, pleasure, recreation, or any other purpose except profit; and 4) that the organization's income is not payable to or made available for the personal benefit of a member, proprietor, or shareholder.

Findings

Not a charity

To qualify as an NPO under paragraph 149(1)(l) of the Act, the club, society, or association cannot be a charity within the meaning assigned by subsection 149.1(1) of the Act. In other words, an organization that is a charity, whether registered or not, is excluded from qualifying as an NPO.

However, the NPORIP identified a small number of cases where the organization was, in fact, a charity (including cases where the organization was a registered charity and had filed a non-profit organization information return in error and cases where the organization was found to be a charity at common law, but had not registered with the CRA) and would therefore not qualify to claim the tax exemption under paragraph 149(1)(l) of the Act.

¹ Statistics Canada Catalogue No. 61-533-XIE, Ottawa 79 p. (<http://www.statcan.gc.ca/pub/61-533-x/61-533-x2004001-eng.pdf>); Statistics Canada's estimates do not include citizens' groups that were not formally incorporated or registered with federal, provincial, or territorial governments, and are based on a definition of NPOs that differs slightly from the conditions set out in paragraph 149(1)(l) of the Act.

² *Tax Expenditures and Evaluations Report, 2012*. Department of Finance Canada, 2013.

³ The NPORIP sample was selected from organizations that filed a T2 corporation income tax return, a T1044 non-profit organization information return, or a T3 trust income tax and information return in 2009, 2010, or 2011.

Organized for a purpose other than profit

To qualify for the tax exemption under paragraph 149(1)(I) of the Act, the organization must be both organized and operated exclusively for a purpose other than profit.

It is important to note that it is the CRA's view that making a profit will not in and of itself prevent an organization from qualifying for the tax exemption under paragraph 149(1)(I) of the Act, as long as these profits are incidental and arise from activities that are undertaken to meet the organization's non-profit objectives.

However, the NPORIP identified a small number of cases where the organization's governing documents (such as articles of incorporation, letters patent, and by-laws) indicated that it was not **organized** exclusively for a purpose other than profit.

Operated for a purpose other than profit

The NPORIP also identified a significant number of cases where the organization was not **operated** exclusively for a purpose other than profit.

In addition, the NPORIP noted a variety of activities with apparent profit motives carried out by a wide range of organizations. The NPORIP also identified a significant number of cases where the organization had disproportionately large capital or operating reserves that resulted from surpluses generated by non-incidental profits.

More broadly, the NPORIP also observed that many in the non-profit sector believe that NPOs must produce a profit for their programs to thrive and for their capital assets to be maintained. In particular, there is a common view that, as long as profits are used to further the organization's purpose, the source of the funding shouldn't matter. However, it is the CRA's position that a NPO can earn profits, but the profits should be incidental and arise from activities that are undertaken to meet the organization's non-profit objectives. The earning of profit cannot be or become a purpose of the organization, even if the profit is earned to fund non-profit objectives.

No income payable to or available for the personal benefit of any proprietor, member, or shareholder

To qualify for the tax exemption under paragraph 149(1)(I) of the Act, no part of the income of the organization can be payable to, or otherwise available for the personal benefit of, any proprietor, member, or shareholder.⁴

Income payable or otherwise available refers to direct or indirect amounts that result in a benefit to the proprietor, member, or shareholder of the 149(1)(I) organization. This includes items such as shareholder loans, the ability to pay dividends, and the guaranteeing of personal loans for any proprietor, member, or shareholder of the organization.

⁴ An exception applies if 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 in which income may be payable or available for personal benefit.

The NPORIP identified a small number of cases where the organization had income payable or made available for the personal benefit of a proprietor, member, or shareholder.

Other

Paragraph 149(1)(l) of the Act is an inclusive provision, which means that almost any type of organization can qualify under the provision. The terms **social welfare, civic improvement, and pleasure or recreation** are not defined in the Act; similarly, the phrase **or for a purpose other than profit** allows almost any type of organization to potentially qualify for the exemption without being restricted in its activities and objectives (other than profit). The NPORIP shows that the current legislative framework allows many different types of organizations with a wide variety of purposes and activities to claim the exemption.

The NPORIP found that many organizations have a different interpretation than the CRA about when an organization meets the conditions of paragraph 149(1)(l) of the Act. The NPORIP also found that many organizations are administered by non-specialist volunteers who generally want to comply with the income tax rules, but who may not fully understand their requirements under the legislation.

More broadly, comments received from the non-profit sector during the NPORIP indicate that more education and outreach on the part of the CRA related to paragraph 149(1)(l) of the Act would be beneficial.

Summary

The NPORIP was designed to provide the CRA with insight into the way certain organizations—those seeking an exemption from tax under paragraph 149(1)(l) of the Act—operate under the income tax rules. The NPORIP has given the CRA a better understanding of the issues these organizations face in complying with the Act, and, in particular, has highlighted a number of areas where the non-profit sector's understanding of the law differs from that of the CRA. In addition, the NPORIP has revealed a significant issue with compliance by these organizations in several key areas.

The results from the review of the randomly-selected organizations suggest that a significant portion of incorporated organizations would fail to meet at least one of the requirements set out in paragraph 149(1)(l) of the Act.⁵ Of these:

- A significant portion would fall into a higher category of risk, which includes organizations earning profits that were not incidental or not related to their non-profit objectives; organizations with disproportionately large reserves, surpluses, or retained earnings; and organizations where income is payable or made available for the personal benefit of a proprietor, member, or shareholder. Many of the organizations that fall within this higher-risk category would not actually qualify for the tax exemption under paragraph 149(1)(l) of the Act and would need to be reassessed if they were audited

⁵ As noted above, these findings cannot be generalized to unincorporated organizations.

outside the purview of the NPORIP, which would in most cases result in an increased tax liability to the organization.

- A small portion would fall into a lower category of risk, which includes readily correctable issues, such as making filing errors or not providing enough information to substantiate a not-for-profit purpose in the organization's governing documents.

Based on its review, the CRA recognizes that education and outreach with the non-profit sector are critical to improving many organizations' compliance with paragraph 149(1)(l) of the Act. Accordingly, it will work with representatives of the non-profit sector to determine how the sector's knowledge of the income tax rules can be improved. The CRA will also look to improve NPOs' understanding of their income tax obligations through targeted outreach activities, client service, and education. As part of this work, the CRA will review, revise, and improve as required the educational materials and support it provides in this regard. Finally, because the review also reveals that the legislative framework may benefit from further examination, a copy of this report will be provided to the Department of Finance Canada for information and consideration.