The Present and Proposed Taxation of Non-Profit Organizations

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INTRODUCTION

The taxation of non-profit entities involves in itself a contradiction of terms. Section 2 of the Income Tax Act\(^1\) imposes a tax on the income of a person and section 4 defines income from a business or property as "the profit therefrom". In that case, a truly non-profit entity, that is, one which makes no profit, need not be concerned with taxation since its income would be nil. However, this is not the sense in which we use the word "non-profit". Of course, some non-profit entities in fact make no profit, for example, a service organization providing its services at cost. But we are not concerned with these entities, since they have no income which could be taxed. Instead, we are concerned only with those entities that make a profit, but which are described as non-profit in the sense that they don't distribute that profit to their proprietors, shareholders or members. Of this group, there are basically three types: first, the charitable organization; second, the private club or society; and third, a number of special organizations such as labour unions.

At present these entities are exempted from tax by the various subsections of section 62 [section 149 of the Bill\(^2\)]. The exemptions are total — that is, they pay no tax at all if they conform with one of the exempting subsections. Therefore we shall firstly examine these subsections as they apply to each of the basic types of non-profit organizations. Secondly, we shall consider some of the criticisms of the present system and suggestions for future reform.

THE TAXATION OF CHARITABLE ORGANIZATIONS

There are two types of charitable organizations which are exempt from tax under the Canadian Income Tax Act. The first is the organization that actually operates a charity, which is exempt by virtue of s. 61(1)(e) [s. 149(1)(f) of the Bill], and the second is the organization that distributes its funds for charitable purposes, which is exempted by s. 62(1)(f) and s. 62(1)(g) [ss. 149-(1)(g) and (h) of the Bill].

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* Members of the 1971 graduating class of Osgoode Hall Law School.
1 R.S.C. 1952, c. 148, as amended.
2 Bill C-259 to amend the Income Tax Act and other Acts, hereinafter referred to as the Bill.
Charitable Organizations that operate Charities, s. 62(1)(e).

An organization is entitled to an exemption under s. 62(1)(e) only if all its resources are devoted to charitable activities which it carries on itself. Thus no part of its income may be given to another charity, but it must all be expended on some charitable project carried on under its own direct supervision and control.

The biggest problem in interpreting s. 62(1)(e) is the meaning of the word "charity". The words "charity" or "charitable organization" are nowhere defined in the Act and therefore we must look elsewhere for their meaning. The leading case is Pemsel v. Special Commissioner. In this case Lord MacNaughton defined "charity" by a division into four classes: "trusts for the relief of poverty, trusts for the advancement of education, trusts for the advancement of religion, and trusts for other purposes beneficial to the community not falling under any of the other heads."

It is not the purpose of this paper to discuss the common law meaning of the word "charity" and what sort of organizations are likely to be held not charitable. For the present, let us consider only organizations which are clearly charitable.

However, a question which we must consider is whether an organization, clearly charitable, can carry on a business and still retain its charitable character. In the case of Royal College of Surgeons of England v. National Provincial Bank Limited it was held that a charitable corporation remains charitable even though it promotes other interests or purposes, provided such purposes are merely incidental to the main object. In other words, a charitable organization could carry on a business so long as that purpose were merely ancillary to its main purpose, which would be charitable. In addition, it can be argued that s. 62(1)(f) and s. 62(1)(g) make it clear that the organizations described there cannot carry on any business and because no similar exclusion is set out in s. 62(1)(e) a charitable organization could be such within the meaning of s. 62(1)(e) even if it carried on a business. In a lecture given to members of the Canadian Tax Foundation in 1960, Mr. Arthur W. Gilmour, C.A., said that it would appear that an organization as long as its activities were charitable could "carry on a commercial, industrial or financial business, as long as the resources of the organization were devoted to charitable activities carried on by itself."

Also, in M.N.R. v. Begin, the Exchequer Court of Canada held that a partnership which operated a beer business but where all the profits were to be distributed for purposes of social welfare, charity, education and civic improvement, was nevertheless entitled to an exemption under s. 62(1)(e). This was a clear case of a charitable organization operating a business and yet retaining its charitable character.

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3[1891] A.C. 531.
4Id. at 583.
On the other hand, however, there is a Supreme Court of Canada decision on this question which may throw doubt on the strength of the rules stated in the Royal College of Surgeons case. In R. v. The Assessors of the Town of Sunny Brae, the court had to deal with a New Brunswick Act exempting from municipal taxation "the property of any literary or charitable institution". In that case, a society whose objectives were the advancement of education and the relief of poverty, carried on a laundry and drycleaning business which was described as being "very extensive", and involved the operation of two motor cars for picking up and delivering clothing and considerable laundry and drycleaning equipment. Three members of the Supreme Court, Chief Justice Rinfret and Kerwin and Cartwright, J.J., held that notwithstanding the operation of the laundry and drycleaning business the Society remained a charitable institution because in its objects the running of such a business was described as "incidental" to its main objects and the income produced was used for charitable activities. Mr. Justice Cartwright delivering the judgment for those three members of the court said: "This is not the case of an institution carrying on a commercial business and incidentally performing sundry charitable work or paying over its profits to be used by others for charitable purposes, but rather that of a society or institution of which all the primary purposes are purely charitable which is actively engaged in carrying on charitable works and which as an incidental means of providing some of the money which is required for the prosecution of such charitable works, carries on a business under statutory powers."

On the other hand, Mr. Justice Rand in a judgment agreed to by Mr. Justice Locke, said that they were considering a case of a society of "mixed objects and works or activities, some of which are charitable and some not." He said: "We have to-day many huge foundations yielding revenues applied solely to charitable purposes; they may consist, as in one case, of a newspaper business; even if these foundations themselves carried on the charitable administrations, to characterize them as charitable institutions merely because of the ultimate destination of the net revenues, would be to distort the meaning of familiar language; and to make that ultimate application the sole test of the charitable quality would introduce into the law conceptions that might have destructive implications upon basic principles not only of taxation but of economic and constitutional relations generally. If that is to be done, it must be done by the legislature."

Mr. Justice Kellock thought the society was not charitable because he found the operation to be conducted with "commercial considerations in view and on commercial principles". As an entirety he said, the society could not be the object of a valid charitable trust and could not therefore be said to be a

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8 [1952] 2 S.C.R. 76.
9 Id. at 85.
10 Id. at 92. Note also that this statement is an express denial of the "destination of income" test laid down in Trinidad v. Sagrada Orden de Predicadores (1924), 263 U.S. 578 where the Supreme Court of the United States said that it was not interested in how money was raised but rather how it was used. If the earnings were applied for purely charitable purposes the organization should not lose its exemption even though the income was derived from non-charitable activities.
charitable corporation.  In effect, he considered the organization not to be charitable within the definition in *Pensel's* case.

Three judges then said the society was charitable, and three said it was not, and the other judge, Mr. Justice Estey, did not get to the question of "charity" because he dealt with the case as a matter of statute interpretation as falling under a different section of the Act. As a result, there was no clear decision by the Supreme Court of Canada on the question of whether a charitable corporation can operate a business and still retain its charitable character. In its absence, we can only assume that the principle in the *Royal College of Surgeons* case still stands.

It should also be noted that an organization is entitled to exemption only if "all its resources" are devoted to charitable activities. This is usually interpreted to mean simply that it cannot retain a part of its income for the year as a reserve. For example, in the *Pas Lumber Company Limited v. M.N.R.*, although the capital of the organization in question was approximately $20,000.00 in its first year it used only some $475.00 of its interest income for charitable activities. The Tax Appeal Board decided that all its resources were not devoted to charitable activities.

As has been discussed above, however, the restriction that "all the resources" are to be devoted to charitable activities has not been interpreted as meaning that the charity cannot carry on a business, as long as it is merely incidental to its charitable purposes.

The last requirement of s. 62(1) (e) deserving comment is the part prohibiting income from being payable to or otherwise available for the personal benefit of any proprietor, member or shareholder. Words similar to these are contained in several subsections of s. 62, and their interpretation will be discussed later on under a discussion of s. 62(1) (i).

*Organizations Distributing Funds for Charitable Purposes, Ss. 62(1)(f) and 62(1)(g).*

The organizations covered by these sections are those which have been constituted exclusively for charitable purposes but distribute at least part of their income to other charitable bodies rather than devoting all their resources to their own charitable activities. If the organization is a corporation it can be exempted under s. 62(1) (f) and if a trust under s. 62(1) (g). In both cases it is subject to the same conditions. Note also that an organization actually carrying on a charitable activity presumably could also be exempted under s. 62(1) (f) or s. 62(1) (g) but it is more preferable for it to get an exemption under s. 62(1) (e) since, as we shall see, it would not be subject to the greater restrictions imposed by s. 62(1) (f) and s. 62(1) (g). Conversely, the M.N.R. would prefer to grant on exemption under s. 62(1) (f) or (g) than under s. 62(1) (e).

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11 *Id.* at 101.
12 *Id.* at 104.
13 59 D.T.C. 95 (T.A.B.).
14 See text, *infra*, at 369.
Identical with those in s. 62(1)(e), an organization seeking exemption under s. 62(1)(f) or (g) must be constituted exclusively for charitable purposes, and no part of its income may be payable to or otherwise available for the personal benefit of any proprietor, member or shareholder thereof.

In addition, however, it must conform to several other conditions.

The organization may not, since June 1st, 1950, have "acquired control of any corporation". "Control" is defined for this purpose in s. 62(3)(a) [s. 149(7)(a) of the Bill] and an organization "shall be deemed not to have acquired control of a corporation if it has not purchased (or otherwise acquired for consideration) any of the shares in the capital stock of that corporation". Thus, if a charitable organization, as a result of a gift or gifts of shares acquires control of another corporation, then, provided it has not purchased any shares of the controlled corporation, it will still be eligible for exemption under s. 62(1)(f) or (g).\textsuperscript{15} If, however, a charitable organization had purchased a minority interest in a corporation and later received as gifts sufficient shares to give it control, it would lose its exemption.

The organization is specifically prohibited from carrying on a business. Recall that this specific prohibition can be argued to authorize the business activity of an organization exempt under s. 62(1)(e), since that subsection doesn’t have a similar specific prohibition.

The organization must (unless prior to January 1st, 1940 it was constituted exclusively for charitable purposes) expend at least 90% of its income each year on any combination of charitable activities carried on by itself, gifts to charities exempt under s. 62(1)(e), gifts to charitable \textit{corporations} exempt under s. 62(1)(f), or gifts to the Government of Canada, a province, or a municipality. Note that gifts to charitable trusts exempt under s. 62(1)(g) are not included in the list of permissible expenditures.

However, it is provided in s. 62(4) [s. 149(9) of the Bill] that in computing its income, a charitable organization may deduct "an amount not exceeding its income for the year preceding" but shall include "any amount that has been deducted under this subsection for the immediately preceding taxation year". It is also provided in s. 62(5) that in its first taxation year "the whole or any part of amounts expended by it in the immediately subsequent taxation year shall "if it so elects" be deemed to have been expended by it in the first taxation year and not in the subsequent taxation year." The effect of these provisions is to permit the organization to accumulate a reserve equal to its income for the preceding year. In addition, of course, it may accumulate the 10% of its income every year which it is not required to distribute. In this respect, organizations exempt under s. 62(1)(f) or (g) may be better off than those exempt under s. 62(1)(e) since the latter must devote "all the resources" to charitable activities and are thus prohibited from accumulating a reserve.

Also, it is provided in s. 62(3)(b) [s. 149(7)(b) of the Bill] that a charitable organization must include in computing its income, all gifts received by the organization, except those specifically exempted in the same subsection.

\textsuperscript{15} Note, however, that in Ontario, the Charitable Gifts Act, R.S.O. 1970, c. 61, prevents the gifting of an interest greater than 10% of a business to a charitable organization.
Conclusion

There are several deficiencies in the taxation of charitable organizations. In the first place, there appears to be no consistency behind some of the prohibitions imposed by ss. 62(1)(e), (f) and (g). For example, the restriction imposed on operating charities that they must devote all their resources to charitable works is inconsistent with the permission granted foundations that they may accumulate a reserve equal to their preceding year’s income plus 10% of each year’s income. If anything, the operating charities would have a greater need for a reserve fund yet they are precluded from having one despite the fact that foundations are so allowed for no apparent reason. Similarly, foundations are precluded from operating a business or controlling a corporation, but operating charities are not. Again there is no apparent reason for this distinction.

Secondly, there is no valid reason that we can see for these prohibitions to constitute conditions for tax exemption. Certainly if an organization fails to adhere to a relevant prohibition, it ought not to be exempted from paying tax on the income derived therefrom, but why should it lose its exemption with respect to its other income? Thus, for example, if a charity accumulates 25% of its income one year to set up a reserve fund, it ought to be taxed on that portion of its income (assuming the prohibition was relevant in the first place), but still be exempted on the remaining 75% that was expended for charitable purposes.

And lastly, the common law definition of “charity” and its subsequent interpretations are not wholly satisfactory.

THE TAXATION OF CLUBS, SOCIETIES, ASSOCIATIONS, AND NON-PROFIT ORGANIZATIONS

S. 62(1)(i) [s. 149(1)(1) of the Bill] exempts from taxation “a club, society or association organized and operated exclusively for social welfare, civic improvement, pleasure or recreation or for any other purpose except profit, no part of the income of which was payable to, or was otherwise available for the personal benefit of, any proprietor, member or shareholder thereof”. From this section it is obvious that any organization claiming an exemption must fulfil two conditions. The first condition really has two parts; these parts are that the organizations must be one of the correct types (a club, society or association) and the second part is that the correct type must be organized and operated exclusively for one of the correct purposes. The second basic condition is that which appears in almost all the subsections of s. 62(1)—that no part of the income be available for the benefit of any member or shareholder.

We will now go on to consider these two conditions separately.

1. The condition of proper organizations and proper purposes

From the wording of s. 62(1)(i), it would appear that this section is directed towards unincorporated organizations. However, there have been many cases which have held that s. 62(1)(i) does not exclude incorporated
companies. Furthermore, even a company incorporated under Part I of the Canada Corporations Act (i.e. a regular company with share capital) has been held to fall within the definition or meaning of the word "association".

The meaning of the words "civic improvement" has been dealt with in several cases. In Moose Jaw Industrialization Fund Committee v. M.N.R. a special company was incorporated to work for the advancement of a city by encouraging the establishment of new industries in that city. It was held that the association was formed solely for civic improvement. In Forest Lawn Cemetery Company v. M.N.R. a company was incorporated under the British Columbia Cemeteries Act to establish and maintain a public cemetery. It was held in this case that the company was operating solely for civic improvement.

From the above cases and from a consideration of s. 62(1) (i) it is apparent that the organization claiming exemption must be both "organized and operated" exclusively for one of the enumerated purposes. In order to discuss whether an organization is organized exclusively for one of the required purposes, it will be necessary to closely examine the Letters Patent, Memorandum of Association or By-laws of the organization. To determine whether a company is operated exclusively for one of the purposes, it will be necessary to look at the actual conduct and affairs of the organization.

It is most important to always realize that both the organization and operation of the club, society or association must be exclusively for one of the enumerated purposes. Therefore, it would seem that if the institution in question largely carries on its activities to fall within one of the enumerated purposes but also carries on activities which fall outside of the enumerated purposes, then it will not receive the tax exemption it seeks.

It is now essential to consider the meaning of "for any other purpose except profit". If the club, society or association could show itself to be within the meaning of social welfare, civic improvement, pleasure or recreation, then there is no restriction which would prevent the organization from carrying on a business and/or making profit so long as the institution was organized and operated exclusively to further those purposes. But if it is not within the meaning of these enumerated purposes then it must show itself to be "for any other purpose except profit". Then, in this case the carrying on of business or the making of income is a real issue. The leading case as to what is meant by non-profitable purposes is St. Catherines Flying School Limited v. M.N.R. a case before the Supreme Court of Canada. In this case a flying school was incorporated under Part I of the Dominion Companies act as a normal share-capital company. It agreed with the Government to train members of the R.C.A.F. in return for payments. Its charter contained a provision prohibiting the distribution of

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18 1951 D.T.C. 325 (T.A.B.).
19 1951 D.T.C. 84 (T.A.B.).
dividends for the duration of the school’s training contract with the Government. This original contract was replaced by a second one under which the Club agreed not to distribute any surplus earned by it but to pay any such surplus earned to another club approved by the Minister of National Defence, failing which it would go to the Crown. The M.N.R. contended that the profits earned under both agreements were taxable. In the judgment of the Exchequer Court, Thorson, P. explored the meaning of “non-profitable purposes”. First, he held that it does not follow simply that because the taxpayer made profits that the taxpayer organization was not organized and operated for non-profitable purposes. He then continued to state that non-profitable purposes

— cannot mean that the purposes must be such that profit does not result from carrying them on, for the section assumes the possibility of making profits in the course of carrying out non-profitable purposes. The term must, therefore, mean something other than purposes from the carrying out of which profit might possibly result.

In my judgment, the purposes referred to must be purposes that are carried out without the motive or intention of making a profit, that is to say, purposes other than that of profit making.

In the Supreme Court of Canada, Locke, J. did not discuss Thorson, P.’s interpretation of the meaning of “non-profitable purposes”. Therefore, although the judgment of the Exchequer Court was reversed in part, it would seem that this interpretation of the term still stands.

Thus, it is essential to distinguish between purposes which are non-profit in nature and the results of carrying out these non-profitable purposes. That is, it may be that the results of carrying out the non-profitable purposes are that profit is made; however, so long as the club, society or association is organized and operated exclusively for purposes except profit the fact that profit or income may result will not affect the status of the organization.

An example of the narrow distinction between an organization organized and operated exclusively for non-profit versus profit purposes is the case of M.N.R. v. The Lakeview Golf Club Limited. In this case the Golf Club was incorporated with share capital and the shares were owned by no more than seven shareholders. In the years in question the company made a profit but no dividends had ever been paid by the company. The company operated a golf club, membership in which was acquired by the payment of an annual fee. The fee-paying members did not acquire any shares in the company. Non-members also played on a pay-as-you-play basis. The company was assessed for income tax for the years in question. The company contended that it was organized and operated exclusively for recreation or pleasure within the meaning of the exempting section. However, the Exchequer Court held that the company was not organized exclusively for recreation or pleasure because one of the other purposes of the club was to make profit. By-law No. 35 of the company provided that dividends when earned and declared shall be paid to the shareholders. In considering this by-law, Cameron, J. decided that the club

22Id.
2352 D.T.C. 1164, (1952) C.T.C. 278 (Exch.Ct.).
was not organized *exclusively* for recreation or pleasure, but that it was
organized and operated for the purpose of profit making as well:

[t]hat is the clearest possible evidence that the directors and shareholders con-
templated the possibility of profit being earned and that in such a case they would
be available when declared, to the shareholders.24

Also, the fact that the company did in reality make a profit for the years
in question further supported this view.

Therefore, it is again important to reiterate that the very fact that the
by-laws or Letters Patent of the organization even contemplate the future possi-
bility of profits will be sufficient to exclude the organization from falling with-
in the meaning of "organized . . . exclusively . . . for any other purpose except
profit" in s. 62(1)(i). The reasoning is again obvious—any organization which
contemplates the possibility of future earnings cannot be said to be organized *exclusively*
for non-profit purposes. Such a contemplation in the Letters Patent
is fatal to the organization and the fact that it may or may not make a profit is
irrelevant.

All the leading cases in this area of non-profit organizations have fully
considered the Letters Patent, memoranda of association, or by-laws of the
institution in question in order to decide whether or not the institution is one
organized for purposes other than profit. Therefore, it is essential to investigate
these cases.

2. The Effect of the Letters Patent, Memoranda of Association or by-laws of
the Organization in Determining its profit or non-profit status

The leading case in this area as already stated is the *St. Catherines Flying
Training School Limited* case.25 The facts of this case have already been given.26
The Supreme Court of Canada considered the two agreements separately in
deciding whether or not the organization should be taxed. It held that the profits
realized from the company's operations under the first contract with the Crown
were properly taxed as income since the company was carrying out one of its
declared objects for which it was incorporated in its Letters Patent—that is,
the carrying on of such work was one of the declared objects of the company.
The reference to dividends in the Letters Patent of the Company persuaded the
Court that profit making was one of the objects of the Company. Although the
Charter of the Company contained a provision prohibiting the distribution of
dividends for the duration of the school's training contract with the government,
the Court felt that this prohibition against dividends or profits being distributed
was not permanently restrictive and the company could have retained its profits.
However, the Court decided that the profits realized under the second agree-
ment with the Crown were not taxable since the surplus resulting was held by
the Company upon terms which were equivalent to saying that the Company
held the surplus in trust for the Crown.

However, the important point to notice in the case is that the Supreme
Court looked almost exclusively to the powers given to the Company under its

25*Supra* note 20.
26*See* text, *supra* at 365.
Charter to own and dispose of its profits. This power in the Charter governed the issue and not the fact that the Company entered into agreements which precluded its profits from reaching its shareholders or members. The Court attached great weight to the fact that the Company was incorporated under Part I rather than Part II of the Companies Act. Thus, although the essence of the matter was that the Company had placed its profits beyond the reach of its members and shareholders, the fact that legally it had the power to dispose of the profits to the members and shareholders took precedence over all other considerations. In the course of his judgment, Locke, J. reinforced the view that the Letters Patent provisions are to be strictly construed in determining whether an organization will achieve tax exempt status as a non-profit organization:

The question of the liability of the respondent to taxation depends, not upon the intention of the promoters or the shareholders as to the disposition to be made of the profits but rather upon consideration of the terms of the Letters Patent, the nature of the business authorized to be carried on and of the business which was carried on which resulted in the earnings of the income. . . . If the company had succeeded in obtaining Letters Patent which prohibited the payment of dividends completely and, in addition, the retention of any earned income by the company, different considerations, which need not here be considered, would arise.27

Therefore, it is apparent from this part of the judgment that the Letters Patent provisions rather than the actual operations of the company determine whether or not it will get tax-exempt status. On the basis of the decision in the St. Catherines Flying Training School case, it would seem that the decision in Edmonton District Milk and Cream Producers Association Limited v. M.N.R.28 is incorrect. In that case the Income Tax Appeal Board stated that it is not so much what the taxpayer could or might do as what it actually did that counts in determining whether or not the wide powers of the company will destroy the non-profit status of the company.

The courts have often considered external agreements in determining whether or not an organization is tax exempt, e.g. the courts consider company contracts, partnership agreements, and statutory restrictions on the organization. For example, in the case of M.N.R. v. Begin29 a partnership was formed to sell beer in a Quebec town and the partnership agreement provided that the partners would distribute all profits for purposes of social welfare, charity, education and civic improvement. The partnership agreement also specifically provided that the partners could not draw, retain or appropriate any of the sums to be distributed and that, if the partnership were dissolved, all assets would be distributed for the same charitable purposes. The Exchequer Court held that the partnership was exempt from taxation as a non-profit organization since the partners had never received any of the profits and they had no claim and no right at any future time to the profits of the partnership. In the Moose Jaw Industrialization Fund case30 the memorandum of association of the company prohibited the payments of dividends to its members. The Tax Appeal Board, after finding that the corporation was established solely for civic improvement, stated that the problem with regard to what would happen to the

30Supra note 18.
earnings of the company on its winding up could not be considered in determining its tax exempt status since there was no reason to anticipate such a winding up. The Tax Appeal Board stated that such an eventuality is not to be contemplated in interpreting what was then s. 4(h) of the Income War Tax Act (which section is analogous to the present s. 62(1)(i)).

In the Montreal Milk case31 Kearney, J. discussed the effect of a company which has Letters Patent of a commercial nature but which does not carry on these commercial activities. He said, “Even if it be true, as claimed by the appellant, that it did not pursue some of its stated objects of a commercial and gainful nature, such as the purchase and sale of cattle, nevertheless because it had declared objects of such nature, the association cannot, in my opinion, qualify as a company organized exclusively for purposes other than profit.”32 Therefore, it is again essential to remember that the organization of the company (i.e. the Letters Patent) must be such that the company is organized wholly and exclusively for purposes other than profit.

3. Consideration of the Meaning of “No part of the income of which was payable to, or was otherwise available for the personal benefit of, any proprietor, member or shareholder”

The first point to be considered in determining whether income is available or payable for the benefit of a shareholder or member is the effect of earned surplus or undistributed income of the company. Recall that in Begin33 the partnership had profits which could not be distributed to the partners because of the partnership agreement restricting such distribution. Similarly, in the Forest Lawn Cemetery Company case,34 the British Columbia Cemetery Companies Act prevented the profits from being distributed to shareholders. Also, in the St. Catherines Flying Training School case,35 the second contract with the government was considered to be a bar to distribution of profits earned. Furthermore, the Moose Jaw Industrialization Fund Committee case36 stated that the problem of what will happen to the surplus on a potential winding up is not to be contemplated in determining whether a company is a non-profit organization. In contrast, the Lakeview Golf Club case37 stated that since the company had the power to declare dividends although it never had done so and since it used its earned surpluses to make repairs or improvements required by the club in its operation, the club was a profit-making organization.

All of these cases simply represent the proposition that if the Letters Patent or other formal agreements provide a possibility of future distribution of earnings to the members, then it can not be said that no part of the income is available for the personal benefit of the members.

32Id. at 1012, [1958] C.T.C. at 6.
33Supra note 29.
34Supra note 19.
35Supra note 20.
36Supra note 18.
37Supra note 23.
The original leading case in the area of whether profits are available for the personal benefit of members is *Moose Jaw Flying Club Limited v. M.N.R.* 38

In that case the corporation was incorporated as a non-profit organization for the purpose of providing instruction in the art of flying. It had never paid any dividends to its shareholders and in 1941 it amended its articles specifically to prohibit the payment of dividends. The Appellant filed returns for 1940 and 1941 and was granted tax exemption. In 1942 the company went into voluntary liquidation in the course of which its assets were distributed to its shareholders to the extent of $51 for every $10.00 share. The Minister assessed the company for tax on its income in the years 1940 and 1941 on the basis that inasmuch as the Company distributed money during the 1942 liquidation it must be considered taxable in the years in which it was in operation. The Exchequer Court (Angers, J.) decided the case basically on whether or not the income of the company will enure to the benefit of a stockholder or member. Although the case was decided under s. 4(h) of the Income War Tax Act, 39 which section had the words "enure to the benefit" of a member or shareholder rather than the present wording of "payable to, or . . . otherwise available for the personal benefit of" a member or shareholder, it has been held in other cases that there is no significant difference between the two sections. 40 In the *Moose Jaw Flying Club* case, it was held that as long as the capital and accumulated income of the company will enure eventually to the benefit of the shareholders upon a winding up, then the Company cannot come within the provisions of the present s. 62(1) (i). The judge found it to be an inescapable conclusion from the facts of the case that upon the liquidation of the company the profits which were in the form of surplus had to pass to the shareholders and members since they could not go into any other hands by reason of the company's particular form of corporate organization and the provisions of the Companies Act. It appeared that if the company had so altered its corporate status that none of the accumulated profits or capital could ever revert to any shareholder or member but had to be consumed in the continued operation of a flying club or a similar venture, it would have been very difficult for the Court to have upheld a tax assessment.

A similar situation arose in the *Lakeview Golf Club* case. 41 Recall that in that case the company made a profit in each of the three years in question but no dividends had ever been paid. However, By-law no. 35 provided that dividends when earned and declared shall be paid to the shareholders. Cameron, J. in the Exchequer Court considered the issue of whether or not undistributed earnings are income which ensures to the benefit of the shareholders:

While that amount was not distributed to the shareholders, it was at all times possible for the directors to declare dividends to the shareholders to such extent as they had profit on hand. The value of the shares increased to the extent of such income was earned and, therefore, in my opinion such income enured to the benefit of the shareholders or was available for the personal benefit of the shareholders although not, in fact, paid to them. 42

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41 *Supra* note 23.
42 *Id.* at 1166, [1952] C.T.C. at 282.
Therefore, the effect of the undistributed earnings was twofold. First, the surplus on hand increased the value of the shares held by the shareholders in the golf club—that is, the earnings enured to their benefit. Secondly, the profits were potentially available for the benefit of the shareholders. The directors could have, at any time, declared dividends. The fact that dividends were not declared is irrelevant. This second point is somewhat similar to our discussion of the effect of the Letters Patent—if there is a possibility of distribution of profit (or if there is no absolute restriction on the potential future distribution of profit), then it cannot be said that no part of the income is payable to or otherwise available for the personal benefit of a shareholder or member.

Of course, the St. Catherines Flying Training School case is of significant importance since it was decided by the Supreme Court of Canada. Recall that in that case the profits realized under the second agreement with the Crown were held not taxable since the surplus resulting was held by the company upon terms that were equivalent to saying that the company held the surplus in trust for the Crown. The fact that all future avenues of distribution to the members of the company were blocked by the Crown agreement was sufficient to state that there was no possibility that the income of the club would be payable to or otherwise available for the personal benefit of any of the members. However, in the Exchequer Court decision of the St. Catherines Flying Training School case, the court dealt with the question of whether any part of the flying school's income enures to the benefit of any shareholder or member. Thorson, P. indicated the limits which are to be placed on the word "benefit":

That is not the kind of benefit contemplated by this section. Moreover, there is no evidence that any of the six representatives or members would ever derive any personal benefit even if the Appellant's surplus should be turned over to the sponsoring club for the purpose of doing so would be to revive its activities. Therefore, what he was saying, is that the benefit must be real and enure directly to the person mentioned in the section of the taxing statute.

The Supreme Court of Canada held that the second agreement precluded the possibility of any future distribution of profit. The fact that the company could not distribute earnings during the period of its first contract with the government did not effectively close out the possibility of future distributions:

the profits made were the property of the company and there was nothing in the letters patent which prohibited it from retaining them and the prohibition against declaring dividends or distributing profits was restricted to the period of the duration of hostilities or the period during which the company was required to carry on elementary training. . . . There was nothing which prohibited the declaration of dividends or the distribution of profit after that time.

Some resolution of this case with the previous ones should be attempted. It can reasonably be stated that the Moose Jaw Flying Club case implied that once a company has profit, one can never rule out the possibility that it will eventually enure to the shareholders, by winding-up if necessary. Therefore, if there is any possibility of future distribution on a winding-up to the shareholders, then the organization will not achieve tax exempt status under

43Supra note 17.
44Id. at 1237, [1952] C.T.C. at 371.
46Supra note 38.
However, on the facts of the *Moose Jaw Flying Club* case, a liquidating dividend was actually paid to the shareholders and the operations of the company were not so severely limited by the Letters Patent as to rule out all possible profit purposes. The latter situation was the case in the second contract in the *St. Catherines Flying Training School* case where it was impossible to state either that the profits could possibly enure to the benefit of the shareholders in the future or that the Letters Patent provided a possibility of profit-making purposes. In the *Moose Jaw Industrialization Fund Committee* case, the Chairman of the Income Tax Appeal Board distinguished the judgment in the *Moose Jaw Flying Club* case and remarked that profits do not enure to the benefit of shareholders merely by finding their way into the coffers of the company. They must reach the shareholder, and one cannot assume that a company will necessarily be wound up. This would seem to mean that so long as the purposes of the company are such that all possible profit-making ventures are impossible under the wording of the Letters Patent (as long as the company does not fall within one of the four other enumerated possibilities), the fact that profits may eventually be earned in the carrying out of the non-profit purposes will not necessarily force the court to decide that on winding-up these profits will be distributed to the members such that the organization cannot be granted tax exemption.

Finally, one leading Supreme Court of Canada case in which all of these issues were canvassed is *Woodward’s Pension Society v. M.N.R.* The pension society was incorporated with stated objects “to assist in providing funds for the payment of pensions” to employees of the Woodward Stores group of companies. Over a series of years a substantial surplus was built up from the interest differential between the interest it paid on its subscription for shares and the interest it charged employees on their balances owing on share purchases. Also dividends and capital gains on shares added to the surplus. In 1953 the company commenced payments to the trustees of the Woodward Stores pension plan and thereafter provided the trustees with all the funds necessary for the payment of pensions. The bylaws gave the directors no power to apply the surplus other than by paying it to the trustees and the by-laws also provided that upon dissolution all the assets of the company should be conveyed to the trustees. The M.N.R. taxed the company on its income. The company claimed exemption on the basis of s. 62(1) (i); alternately, the company claimed that it had no income subject to tax since it could never appropriate its income for its own purposes, but was required to pay its surplus, and upon dissolution all its assets, to the trustees of the pension plan.

The Supreme Court of Canada first dealt with the issue of whether the company was organized and operated exclusively for any other purpose except profit. Judson, J. had little difficulty in deciding that the company failed to show that it was organized and operated exclusively for non-profit purposes:

> It is true that the appellant is not an ordinary commercial company but a society incorporated under the Societies Act, R.S.B.C. 1936, c. 265, that no part of the

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47 *Supra* note 20.
48 *Supra* note 18.
appellant's property is payable to or otherwise available for the personal benefit of any proprietor, member or shareholder, and that the appellant was organized for the stated object and purpose of assisting in the provision of funds for pensions to be paid to employees and ex-employees of the stores. Nevertheless, this last-named purpose could not be achieved without the share plan which was designed to make a profit to enable the payments to be made to the pension trustees.\(^5\)

Therefore, the Supreme Court of Canada affirmed the principle laid down by the Exchequer Court\(^5\) that an exemption section is to be strictly construed and that the taxpayer must bring himself squarely within it in order to qualify.

Therefore, both courts held that since the basic purpose of the company was to raise money to establish funds for the pension plan, the fact that its manner of raising funds was a non-commercial type of operation and that the actual share transactions themselves produced no profit could not erase the fact that the company was not organized exclusively for purposes other than profit.

The company also contended that it had no income subject to taxation because the net interest received by the company was not income in its hands because it was not received beneficially since it was impressed with an obligation that it be devoted to payment to the pension trust. In other words, the company relied on the judgment in the St. Catherines Flying Training School case where Locke, J. said:

Different considerations apply, in my opinion, to the profits realized from the operations under the first contract and any surplus resulting from the operations under the second contract. As to the latter, it appears to be undoubted that there was no income liable to taxation since the surplus resulting was held by the respondent upon terms that, unless the Minister should consent to its being paid over to a flying club, it was to be paid to the Crown. The status of such monies does not, therefore, differ from that which would have existed had the contracts simply declared, without more, that the respondent would hold any surplus in trust for the Crown. The respondent is, in my opinion, entitled to succeed upon this aspect of the matter, not on the footing that the exempting provisions relied upon affect the matter but on the ground that there was no income.\(^2\)

However, the income received by the company in this case was its own income and was not subject to the legal claim of any other person. The company simply applied the money in accordance with its stated objects. The obligation to pay the surplus to the trustees for the purposes of the pension plan cannot be considered equivalent to saying that the company was a trustee of its surplus funds in favour of the pension trust. In considering this argument, Judson, J. strictly construed the effect of the incorporating instrument and by-laws:

One cannot construct such a trust of the surplus funds out of the instrument incorporating the society and its by-laws. There was, in the first place, no trust of the shares in which the appellant dealt by purchase and sale and by holding. If the incorporating instrument and the by-laws remain unchanged, the surplus funds are to be paid over in a certain way from time to time and the assets on a dissolution of the society are to be distributed in the same way. But this does not establish a trust. There is no obligation to make any payments which would enable the pension trust to assert a claim that the appellant's income was the income of the pension trust. The income might accumulate indefinitely. In fact, no payments were made to the pension trust during the period 1945 to 1951 when the appellant was building up a surplus. The society might never be dissolved, the objects might be changed, and the by-laws changed.

My conclusion is that the incorporating instrument and by-laws do not constitute a declaration of trust but are merely a statement of objects and purposes.

\(^5\)Id. at 1004, [1962] C.T.C. at 14.
\(^7\)Supra note 20 at 1147, [1955] C.T.C. at 187.
There was no income of a trust during the taxation year in question payable to a beneficiary or other person beneficially entitled and the appeal fails on this ground also.

Therefore, it is again essential to consider the effect of the incorporating instrument. The incorporating instrument will be strictly construed in order to determine whether the purposes of the organization include profit-making objects. However, in order for the court to hold that no income enures to the members, there must be an absolute obligation to make all payments to a second body such that the second body (here the pension trust) has a valid legal claim that it is entitled to all monies held by the exempt taxpayer. Such a situation allows the court to consider the exempt taxpayer a trustee for the second body. A statement of objects in the incorporating instrument is insufficient to create this situation because a statement is not an obligation as long as there is a possibility that the by-laws and objects might be changed, then it cannot be successfully argued that no income is payable to or is available for the personal benefit of any member or shareholder.

**Conclusion**

There are several inherent problems in the present method of taxing or granting tax exemptions to clubs, societies, associations and non-profit organizations under s. 62 (1) (i).

As discussed, the organization must be organized and operated exclusively for one of the enumerated purposes. However, the enumerated purposes which are allowed do not seem to adequately cover the policy of this section. There is no reason why organizations operated and organized exclusively for pleasure or recreation should be allowed to earn profits and yet retain a tax exempt status. Generally, in these types of organizations, the public is restricted and membership is usually quite selective. Therefore, public policy would seem to dictate that such organizations do not receive tax exempt status when similar organizations which make a profit and distribute their profit do not get this status.

With regard to those organizations which attempt to class themselves as non-profit organizations, the Act is deficient in that there is no definition of what is meant by such an organization. Therefore, resort must be made to the common law and to the leading case of *St. Catherines Flying School Limited*. However, the meaning of non-profitable purposes which was discussed in that case seems again to fly in the face of the purpose of the legislation. Recall that Thorson, P. stated that profits could be made in the course of carrying out non-profitable purposes. With this type of definition a good draftsman could draft letters patent for an organization such that the purposes are exclusively non-profit, but a necessary result could be that profit is made. In such a case, the organization would still receive tax exempt status. According to the *St. Catherines* case it is the motive or intention of the organization in not making a profit that will allow it to become tax exempt. We would suggest that somewhere in the Act a definition of “any other purpose except profit” be formulated.

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64 Supra note 20.
65 Supra note 22.
or that an organization would be deemed not to be non-profit if it did in fact make a profit. The distinction between purposes of the organization and the results of carrying out those purposes seems to be a meaningless one.

Even if the present classification of non-profit organizations be retained, it again seems meaningless that the court should pay so much attention to the possible future distributions of profit. If the policy of the Act is to fairly readily grant tax exempt status with a wide range of permissible purposes, then there seems to be no reason why taxation couldn't be levied when profits are in fact distributed or when assets are distributed on dissolution. The mere possibility of future distribution of profit seems again to be a poor test.

The strictness with which the courts interpret the letters patent of an organization in determining whether or not there is a future possible benefit which will accrue to a member or shareholder would be a satisfactory test if such a test were codified in the Act. It would not be difficult to present a subsection in the Act to define what is meant by "payable to, or . . . otherwise available for the personal benefit of, any proprietor, member or shareholder". This is especially true since the words appear in virtually every subsection of s. 62(1). A codification could be made in the following manner—the letters patent or documents of formation must be such that there is no possible future distribution of income to the members; that upon liquidation or dissolution there is no possible manner in which the profits or assets could go to the members or shareholders; that there is no way in which dividends can be declared, etc.

The Woodwards Pension case pointed out one deficiency of resorting to the letters patent as a test of determining whether or not there is a possibility of future distribution to the members. A statement of objects in the incorporated instrument was considered insufficient to create an absolute obligation to make all payments to a second body in the Woodwards case. The reason for this is that the statement is not an obligation, it is simply a statement of intention. However the courts never seem to have considered this paradoxical situation in resorting to the close scrutiny of the letters patent. Such an inconsistency would tend to support the view that the court should look much more closely at the results of the organizations' operations rather than the stated objects.

THE TAXATION OF MISCELLANEOUS NON-PROFIT OR CHARITABLE ORGANIZATIONS

Section 62(1) (b) — Municipal Authorities, and

Section 62(1) (c) — Municipal or Provincial Corporations

Section 62(1) (b) exempts certain municipal or public bodies from taxation. The exemption includes school district bodies, rural and unorganized district bodies, and incorporated municipalities. All of these organizations are creations of provincial governments. Note that the municipality must be in Canada and that the function of government must be performed in Canada.

Supra note 49.
Section 62(1) (c) exempts from tax the taxable income of any corporation, commission or association at least 90% of the capital of which was owned by the federal government, a provincial government or a Canadian municipality. It also provides for the exemption from income tax of any corporation which is the wholly owned subsidiary of such a corporation, commission or association. The exemption does not apply for the 1969 and subsequent taxation years where a person other than Her Majesty in right of Canada or a province or a Canadian municipality had any right to acquire capital stock of the corporation, commission or association or the wholly owned subsidiary (or the parent of the wholly owned subsidiary). Section 84(2), which is applicable to taxation years commencing after 1951, provides that section 62(1) (c) does not apply to any corporation which is specified in Schedule “D” to the Financial Administration Act. Such corporations are owned by the Federal Government and are subject to income tax as provided by section 84. However, a wholly owned subsidiary of such a corporation appears to be exempt under section 62(1) (c) unless the subsidiary is also specified in Schedule “D” to the Financial Administration Act.

Section 62(1)(d) — Agricultural Organizations,
Boards of Trade and Chambers of Commerce

In order for an organization to fall within this section it must fulfil two conditions. The first is that it must be one of the enumerated types of organizations; the second is that no part of its income can be payable or available for the benefit of members or shareholders.

The meaning of agricultural organizations has been considered in two cases. Basically, they are organizations concerned with the advancement of agriculture. This covers the practice or the science of cultivating the ground, but is not confined to this and includes all activities coming within the ordinary meaning of agriculture, such as the raising of livestock. 67

Section 62(1)(ga) — Low Cost Housing Corporations

This section provides for the exemption of a corporation constituted exclusively to provide low cost housing accommodation for the aged. Again it is essential that no part of the income be payable to or available for the benefit of any member or shareholder.

Section 62(1)(gb) — Canadian Universities Foundation

This section exempts the Canadian Universities Foundation from paying tax upon its taxable income. The Canadian Universities Foundation is a corporation incorporated under federal jurisdiction and is the successor to the National Conference of Canadian Universities.

Section 62(1)(gc) — Non-profit Corporations for Scientific Research

This section exempts from tax certain corporations which comply with the following conditions:

1. The corporation must be constituted exclusively for carrying on or promoting scientific research. Although scientific research is not defined, it will presumably have the meaning given to the expression by section 72(4)(b) and the Income Tax Regulations, Part XXIX.

2. No part of the Corporation's income may be payable or available for the benefit of any proprietor, member or shareholder.

3. The corporation may not have acquired control of any other corporation. Control is defined in section 62(3a) if more than 50% of its issued share capital belongs to the other corporation or to the other corporation or persons with whom the other corporation does not deal at arm's length.

4. The corporation may not carry on any business.

5. The corporation must have expended in Canada amounts which are either expenditures on scientific research directly undertaken by it or payments to an association, university, college or research institution to be used for scientific research. Approved institutions are described in section 72(1)(a)(ii) or (iii) or section 72(4)(a). The aggregate of the amounts expended on scientific research must not be less than 90% of the corporation's income for the taxation period. However, the effects of section 62(4) and section 62(5) is that the corporation is permitted to accumulate and keep on hand as a reserve an amount equal to its income for the preceding year. The effect of section 62(3)(9)(b) is that the value of any gifts or contributions made to the corporation must be taken into account in determining the amount which the corporation must distribute during the period in order to qualify for exemption under section 62(1)(gc). In other words, these gifts and contributions must be included in computing the corporation's income.

Section 62(1)(h) — Labour Organizations

This section provides for the exemption of labour unions, lodges, fraternal organizations, benevolent orders or societies. This section is a conceivable "tax loophole" since the only condition to be fulfilled for exemption under this section is that the organization fall within one of the enumerated types. There is no restriction which prevents the organizations in this section from carrying on business or from making profits; furthermore, there is no provision as in most of the other subsections of section 62(1) that the income of the organization not be payable to, or otherwise available for, the personal benefit of any proprietor, member or shareholder. Therefore, it would seem that as long as an organization can be classed as one of the types mentioned in this section, that the organization is free to carry on business, make any amount of profit, distribute this profit to its members or shareholders, and still not be taxed on this income.
Section 62(1a) and section 62(1b) have been enacted to ensure that benevolent or fraternal organizations do not get exemption in respect of taxable income derived from carrying on a life insurance business.

Section 62(1)(j) — Mutual Insurance Corporations

The taxable income of a mutual insurance corporation will be exempt from income tax for any period in which it receives its premium \textit{wholly} from the insurance of churches, schools or other charitable organizations.

Section 62(1)(k) — Credit Unions and Co-operative Credit Societies

This section provides for the exemption of certain corporations or associations which have been incorporated or organized as credit unions or co-operative credit societies. The terms “credit union” and “co-operative credit society” are not defined in the Act and will be interpreted according to their common law meanings.

These organizations will qualify for exemption if they are restricted to carrying on the business in one Province and if they derive their income \textit{primarily} from one or more of the sources listed in subparagraph (i). The essential thing to note is that the exemption will not be denied if a small part of the income is derived from other sources (i.e. profit-making sources). It is a question of fact whether the revenues are derived “primarily” from the sources listed in this section. One important issue under this section is the effect of an organization which carries on its business in more than one province but by its incorporating instrument is restricted to carrying on business in only one province.

If the credit union or co-operative credit society does not qualify for exemption under subparagraph (i), it may qualify under subparagraph (ii). It will qualify under this subparagraph only if all its members are corporations or associations which are listed in (A), (B), or (C) or are corporations or associations no part of whose income is payable to or otherwise personally benefits any shareholder or member. With respect to the question whether a member was incorporated for charitable purposes within the meaning of (C) in subparagraph (ii), the issue is one of the common law meaning of “charitable purposes”.

Section 62(1)(l) — Housing Corporations

The exemption provided by this section is designed to cover the limited dividend housing corporations as set out in the \textit{National Housing Act}, R.S.C. 1952, c. 188.

Section 62(1)(p) — Co-Operative Corporations

A co-operative corporation which is exempt from taxation by virtue of section 73 does not have to pay tax on its taxable income for the period in which it had such exemption.
Sections 62(1)(q), (r), (ra), (rb), (rc) — Trusts Established for the Administration of Pensions, Profit-sharing Plans, Supplementary Unemployment Benefit Plans, Registered Retirement Savings Plans, Deferred Profit Sharing Plans

These trusts are exempt from taxation on their taxable income for the period in which they were organized for the types of trusts as mentioned.

SUGGESTIONS FOR REFORM OF TAXATION OF NON-PROFIT ENTITIES

Introduction

The present exemption from taxation of charities and other non-profit organizations is difficult to justify. The significant provisions of section 62 of the present Income Tax Act are effectively identical with those of section 57 of the 1948 Income Tax Act and analogous to section 4 of the Income War Tax Act. Thus the taxation of these entities has remained unchanged since income tax was first imposed on this country. At that time, the economic significance of income taxation was not as great as what it is to-day. To-day, income tax is the federal government's greatest source of revenue, and the exemptions allowed in section 62 are concerned with vast quantities of income. Therefore, non-profit exemptions ought not to be continued to-day without proper justification.

The Carter Commission recognized this problem: "In fact, organizations have been extended exempt status over the years without the establishment of any clear principles as to why such exemption should be granted and who should receive it." The Commission then went on to discuss the problem and make recommendations to which we will refer later. Unfortunately, however, the White Paper proposed only to subject the investment income of some of the organizations described in section 62(1) (i) to corporation tax. This proposal is now being put into force by section 149 (5) of the Bill.

Thus we can see that the situation at the present time is far from clear and there is a need to re-examine the rationale behind the exemption of non-profit entities. Since these exemptions have been in force for many years already, we would like to conduct such examination in the light of the consequences of our present day exemptions, and whether these consequences are justified.

In our opinion there are two important consequences of tax exemption. The first is the fact that tax exempt entities are in fact publicly subsidized, and the second is the creation of unfair competition.

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68S.C. 1948, c. 52.
69S.C. 1917, c. 28.
60Report of the Royal Commission on Taxation, hereinafter referred to as The Carter Commission.
61Id. V. 4, 128-9.
63Note that section 149(5) of the Bill applies only to clubs, societies or associations whose main purpose is to "provide dining, recreational or sporting facilities for its members".
Public Subsidy

The simple fact that most entities pay a tax on their income means that those entities that are exempt from tax are in a sense subsidized by the taxpaying entity. Income tax to most organizations is an inherent operating expense just like rent. Therefore, a tax exempt organization is subsidized in two ways. First, it is freed of the inherent expense of tax, and secondly, all other taxpayers must pay just a little bit more to make up for the taxes not paid by exempt entities, or, perhaps a better way to look at it is, assuming that the government’s revenue needs remain the same, if tax exempt organizations were to lose that status and be required to pay income tax, all other taxpayers’ taxes would be correspondingly lower.

Therefore, in our opinion, if an entity is to receive a public subsidy in the form of tax exemption, there must be some justification. This justification may be in either of two ways. There should be either a compensating economic benefit to the public or, at the very least, an aesthetic benefit to the public. In most cases, these two justifications will go hand in hand. For example, an entity organized for the purposes of educating the mentally retarded serves the public in both a moral sense and in an economical sense, since mentally retarded people, if not educated, would constitute an expense requiring public funds. On the other hand, there may be public moral justifications in sending Christian missionaries to Africa, but no economic public benefit. In either case, however, there is some sort of a public benefit served by the organization. For this reason, it justifiably receives a public subsidy in the form of tax exemption.

It could be argued that the taxation system should not be used for the purpose of providing public subsidies. In our opinion, however, such an argument is not realistic. Perhaps in theory the aim of taxation is merely to provide public revenue on an equitable basis, and problems of public incentive and subsidy ought to be irrelevant. But, in fact, these problems have always been considered in a basis for taxation and we believe that in the interest of efficiency they ought to remain so. After all, it is far more efficient to simply not tax the appropriate entities, than to tax them with the one hand and reimburse them with the other.

What must be found, however, is a fair basis for providing public subsidies in the form of tax exemption. In our opinion, the present exemption sections do not do so. The fact that an entity is precluded from distributing its profits to its members is not sufficient justification. Certainly, if the members receive no profits then they should not be taxed on them, but this isn’t a justification for exempting the organization itself. As we have already stated, the only justification for the latter should be some sort of public benefit.

In our opinion, a fair basis for exemption ought to be premised on a proper definition of “charity” and “for charitable purposes”. If we can define that word to mean effectively “an activity worthy of public subsidy” then the problem is solved. With such a definition, an exemption would be granted to any organization actually operating a “charity” or organized “for charitable purposes”. By definition, these organizations would be providing a public benefit and thus entitled to public subsidy. All other organizations would not be
exempt (or at least their exemption could not be justified by a public subsidy argument).

At this point we are not prepared to draft a conclusive definition of charity. Suffice it to say that the definition in *Pemsel's* case is not appropriate, as the *Carter Commission* recognized,\(^6^4\) nor would its slight modification\(^6^5\) do the job. What would be required would be a comprehensive definition including all activities worthy of public subsidy and excluding all those not so worthy. The definition in *Pemsel's* case does not accomplish this.

The end result would be that only organizations which were charitable under the new definition would receive exemption. This is as it should be, we believe. There is no reason why a public benefit social club organized for the recreation of its members should receive a public subsidy in the form of tax exemption. The same can be said of labour unions, and credit unions, organized solely to benefit its members. Of course, entities organized for social welfare, civic improvement, to provide low cost housing accommodation for the aged, to carry on or promote scientific research, or for some other similar purpose, ought still to receive an exemption, but such organizations would be included in our new definition of "charity".

These new proposals would greatly simplify the tax laws in our opinion. There would be a codified definition of "charity" and "for charitable purposes" and the restriction that no benefit could enure to a member. Of course there would be problems in interpretation of our new definitions, but we doubt that this will prove to be any more difficult than the interpretation of the common law definitions. Thus, our scheme would simply exempt charitable organizations and tax all others.

**Unfair Competition**

But this conclusion does not mean that charitable organizations should be exempt on all their income, for this too would be inequitable. There can be no doubt that unfair competition results when exempt entities compete with tax-paying entities in the same business. Also, there can be no argument with the *Carter Commission's* premise that "there should not be any tax concessions that give one business a competitive advantage over another, and the present exemption of business income earned by charities could well be regarded as such an advantage."\(^6^6\) The *Commission's* conclusion is unavoidable: "No business activity of a charitable organization should be given a competitive advantage."\(^6^7\)

However, having thus concluded, the *Carter Commission's* recommendations would fail to put into practice what it had preached. Instead, its system of taxing charities is based on a moral judgment of what it believes to be proper and reasonable activities of such an organization. To illustrate this bias, we point out the following: "The primary purpose of a charity is to collect donations and then to apply these funds in a manner prescribed by the organization;

\(^6^4\)The *Carter Commission*, V.4, 132.
\(^6^5\)Id.
\(^6^6\)Id. V.4, 131.
\(^6^7\)Id.
it is not a basic function of a charity to be in business in competition with other business operations. . . . It is not uncommon for a charitable organization to have funds available in excess of its current requirements, and the investment of these funds to earn income is a reasonable function of the organization.”

In other words, the Carter Commission says that the receipt of donations and investments of temporarily idle funds are reasonable and proper activities for a charity, but the operation of or substantial involvement in a business are in some way not proper activities. Interestingly when it comes down to its actual recommendations, the Carter Commission proposes continuing tax exemptions for donation and investment receipts, but taxing all business income. Note also that the Carter Commission claims that the justification for these proposals is to prevent unfair competition, since it states: “A conclusion on the tax treatment of competing businesses is required, and we recommend that the tax exemption should not be extended to business income.”

We have already pointed out that the Carter Commission believed that there was something inherently improper in a charity’s involvement in business, and it is our contention that its proposals were based on this moralistic bias rather than on the pure logic of the prevention of unfair competition.

As some of the critics of the Carter Commission have pointed out, to leave investment income untaxed is to perpetuate unfair competition. A taxable investor is looking at his after tax return when he considers making any investment whereas a charitable organization can make the investment at a considerably reduced interest rate and still get a better return than the taxable investor. Obviously, the borrower is in a better position when dealing with a charitable investor than with a taxable one. The result is unfair competition. Taxable investors may be forced to accept a lower rate of return than would otherwise be available because charitable investors provide an unfair alternative to the borrower.

The solution of course is simple. If the Carter Commission were really attempting to eliminate unfair competition, it would have proposed taxing charities on their investment income as well. Since it did not, we can only assume that its proposals were motivated by other factors, in this case, a moral judgment.

This is not to say that moral and public benefit have nothing to do with taxation. In fact, as we have already discussed, these are often the very reasons for exempting charitable organizations. But in the case of investment income, its exemption cannot be justified by an unfair competition argument as the Carter Commission has attempted to do. Instead, the exemption of investment income should be justified by a public benefit argument. Complex rules defining what sorts of investments produce sufficient public benefit are required. For example, investments in common shares of private companies which produce little or no income should be discouraged as should holdings of real estate that

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68 Id. V.4, 133.
69 For their definition of “business income”, see V.4, 134.
70 Id. V.4, 134.
are not used to substantially further charitable purposes. On the other hand, exemptions should be allowed to charitable organizations on income-producing lands or real estate used to further its charitable purposes. The end result of these rules must be to grant exemption on the investment income of charitable organizations only when those investments are appropriate to the operation of such organizations in the sense that the public is being adequately benefitted. But in other cases, inappropriate investments should be discouraged by tax penalties.

It is interesting that in the case of private clubs and similar organizations now exempt under section 62(1)(i) of the Act, the Carter Commission recognized that "there is no reason to permit portfolio [i.e. investment] income to be received as part of this tax exempt activity." Therefore, it did propose the taxation of investment income, as well as business income, in the case of these organizations. We wholeheartedly agree with this proposal.

However, the Carter Commission would still grant this type of organization exemption on its income derived from primary purpose activities. Thus, "membership fees and the revenue and bar facilities attributable to their use by members and a limited number of guests are part of the exempt activity." But income derived from investments or activities with outsiders would be taxed. The Carter Commission again justifies its proposals on an unfair competition theory thusly: "We do not feel that this procedure would produce inequities between private clubs and competing organizations."

We cannot agree with this statement. For example, the green fees at a profit-making golf course must reflect the fact that the golf course is taxable as opposed to the membership dues at a non-profit course, no part of which would go for income tax. Thus, a potential golfer will get more value for his money by becoming a member of a non-profit club. This situation is further aggravated by the fact that any expansion of recreational facilities at the club would be paid for with tax exempt dollars, whereas if the member were to go out and purchase those additional benefits, he could only do so with tax paid dollars. In other words, although he is precluded from receiving pecuniary benefits, he does receive other benefits which are worth much more than they normally would be since no tax is paid on them, either by the club or himself.

The Carter Commission recognized this problem and also its ideal solution: "In principle, income should be imputed to those individuals who merge these income earnings and personal benefit activities; there is no difference in the taxable capacity of those who merge the activities and those who do not." But it concluded, and we cannot argue with it, that this solution was impractical. There is no doubt that the Commission's proposals would lessen the problem, since at least the members' benefits could not then come directly from tax exempt outside business, but it did not go far enough, in our opinion.

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72 The Carter Commission, V.4, 138.
73 Id.
74 Id. V.4, 139.
75 Id. V.4, 137.
76 Id.
Granted that it would not be practical to tax members on non-pecuniary benefits, often intangible, received from private clubs, but is this any reason for exempting the club itself from corporation tax? In our opinion, the taxation of such a club on all its income would at least eliminate the competitive edge it had over profit-making competitors to the extent that a part of the members' dues would go for the club taxes, just as a part of a golfer's green fees at a profit-making course does.

Our proposal to tax these organizations on all their income (i.e. to eliminate the exemption entirely) would also remove a potential problem in the Carter Commission's proposals, namely, the definition of what constitutes business income. For example, would "the lunchroom activity of a golf course located 13 miles from the nearest restaurant be considered a service or a business activity?"

From the point of view of unfair competition, there is not much more that we can say that we have not already said about the Carter Commission's proposal to tax those entities like labour unions, professional organizations, boards of trade, and agricultural organizations. It proposed to tax them like charities, that is to tax their business income but exempt their investment income. The only difference would be that "contributions and donations to these organizations... would not be deductible as charitable contributions, but would usually qualify as ordinary business or employment expenses."

We would also treat them as we would charities, if they come within our definition, and tax them on both inappropriate investment and business income for reasons of unfair competition.

In short, in order to prevent unfair competition, and provide a more equitable taxation system, we would propose the reducing of existing tax exemption for charitable and non-profit organizations in all cases except where there is a sufficient benefit to the public to justify such an exemption.

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77 Asper, supra note 71 at 12.
78 The Carter Commission, V.4, 140.