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PRINCIPAL ISSUES: In the various scenarios presented will the NPO lose its exemption under par. 149(1)(l)?

POSITION: It depends

REASONS: Distribution of income to members will cause NPO to lose exemption. The distribution from capital gain or capital is not a distribution of income.

XXXXXXXXXX

A. Messore

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2013-047410

November 20, 2014

Dear XXXXXXXXXX:

Re: Paragraph 149(1)(l) of the Income Tax Act and capital gains

This is in response to your email interpretation requests regarding a client ("entity ") that considers its income to be exempt from income tax pursuant to paragraph 149(1)(l) of the Income Tax Act. You have asked whether the entity will cease to be an entity described in paragraph 149(1)(l) if it distributes proceeds of a capital gain or other assets to its members. All statutory references in this letter are to the Income Tax Act, unless otherwise specified.

Some time ago, the entity received shares of a private commercial corporation ("shares") for the nominal sum of $XXXXXXXXXX. These shares have since gained significant value. The entity, whose main purpose does not include the provision of XXXXXXXXXX for its members, would like to transfer ownership of the shares, or proceeds of the disposition of the shares, to some of its members either before or during its wind-up operations. Some of the entity's members may qualify for exemption under paragraphs 149(1)(c) or (f), but no member has as its primary purpose and function the XXXXXXXXXX in Canada.

You would like to know the tax consequences to the entity of an eventual transfer to its members of the shares, other assets, or proceeds of disposition of the shares, either in the course of winding-up or just prior to winding-up. In particular, you have asked:

1. Whether the non-taxable portion of an entity's capital gain would be included in the definition of income for purposes of subsection 149(2), and whether an exempt entity may distribute to its members the non-taxable portion of a capital gain without affecting its eligibility for tax exemption under paragraph 149(1)(l)?

2. Whether, on winding-up its operations, the entity will continue to be exempt from tax if it distributes all or part of its remaining assets to members whose objects include purposes similar to its own? Would the answer be any different if, in addition:

a. the members are themselves tax-exempt entities under subsection 149(1)? Or

b. the members are qualified donees who issue a charitable donation receipt to the entity in exchange for the assets? Or

c. the transfer is made conditional upon the assets being used by the members for purposes consistent with those objects?

3. Whether the entity will cease to be exempt if it distributes the shares to its members in the course of winding-up? Would this result in the inclusion of taxable income for the entity?

4. Whether the entity will cease to be exempt if it distributes the shares to its members as a gift prior to winding-up? Would this result in the inclusion of taxable income for the entity? If so, can the entity claim a deduction for charitable donations?

This technical interpretation provides general comments about the provisions of the Income Tax Act and related legislation (where referenced). It does not confirm the income tax treatment of a particular situation involving a specific taxpayer but is intended to assist you in making that determination. The income tax treatment of particular transactions proposed by a specific taxpayer will only be confirmed by this Directorate in the context of an advance income tax ruling request submitted in the manner set out in Information Circular IC 70-6R6, Advance Income Tax Rulings and Technical Interpretations.

Our Comments

A club, society or association organized and operated exclusively for social welfare, civic improvement, pleasure or for any other purpose except profit, may qualify for an income tax exemption if it meets certain conditions described in paragraph 149(1)(l). Among other criteria, to be exempt from tax under paragraph 149(1)(l), no part of the income of the entity may be payable to, or otherwise available for the personal benefit of a member, shareholder or proprietor ("member") of the entity. A determination of whether an entity meets the criteria in a particular year must be based on the facts of each case, which can be obtained only by reviewing all of the entity's activities for that year.

We have not been given any details about the nature of the entity, or the type of activities, objects or purposes it pursues. Nor have we been provided with the context in which the capital shares were originally acquired and held, and are now being disposed of. Accordingly we preface our comments below by noting that where assets of an entity are used for purposes unrelated to its objects, such as long-term investments to produce property income, profit may be considered to be one of the purposes for which the entity is operated. The particular facts of your situation would need to be examined in order to determine whether holding shares as a long-term investment could affect the entity's eligibility for exemption.

1) An entity which meets the requirements of paragraph 149(1)(l) will generally cease to qualify for the exemption at a time when it no longer satisfies the conditions of that paragraph. One such condition is that the entity must not distribute any part of its income, either directly or indirectly, to, or for the personal benefit of any member, except if the member is an association the primary purpose and function of which is the promotion of amateur athletics in Canada.

Income for purposes of paragraph 149(1)(l) is determined in accordance with section 3, taking into account that subsection 149(2) excludes from the calculation of an entity's income the amount of any taxable capital gains. This means that an entity may distribute taxable capital gains to its members and still meet the conditions of paragraph 149(1)(l) as this would not constitute a distribution of income. The non-taxable portion of a capital gain is not included in the definition of "income" at section 3 and therefore payments of such amounts to members would also not affect an entity's eligibility for exemption under paragraph 149(1)(l).

2) An entity will no longer qualify for the exemption provided by paragraph 149(1)(l) at the time when a determination is made that, upon winding-up, an amount of income will become payable to, or otherwise available for the benefit of, a proprietor, member or shareholder of the entity.

The fact that one or more of the members of an entity may itself qualify for the tax exemption provided by paragraph 149(1)(l), or is a "registered charity" as defined in subsection 248(1), or is a qualified donee as defined in paragraph 149.1(1) will not relieve the entity of the necessity of complying with the conditions of paragraph 149(1)(l), and in particular, the condition that it not distribute or otherwise make available any part of its income for the personal benefit of a member. Likewise, the fact that an entity distributes income to members on condition they use it for purposes consistent with the objects of the entity does not relieve the entity of the necessity of complying with the condition that it not distribute or otherwise make available any part of its income for the personal benefit of a member. The non-distribution condition applies regardless of whether an entity receives a charitable donation receipt in return for the transfer of assets to its members.

3) An entity that meets the conditions of paragraph 149(1)(l), may cease to qualify for the exemption on a winding-up, dissolution or amalgamation if it distributes assets to its members (other than a member whose primary purpose and function is the promotion of amateur athletics in Canada) which results in any part of its income being thereby distributed. Income for this purpose is determined in accordance with section 3, taking into account that subsection 149(2) effectively excludes the amount of any taxable capital gains from the calculation of the entity's income.

At the time when an exempt entity that is a corporation no longer meets the conditions of paragraph 149(1)(l), it ceases to be exempt. According to subsection 149(10), the taxation year of the corporation is deemed to have ended immediately before that point in time when it ceases to be exempt, and the corporation is deemed to have disposed of all of its assets immediately before that time and reacquired them at fair market value at that time. The deemed disposition will be tax-exempt since it is reputed to take place while the entity still meets the conditions of paragraph 149(1)(l).

Where a corporate entity ceases to be exempt from tax, subsection 89(1.2) applies to reduce the corporation's capital dividend account to nil. Any amounts that would have been added to the capital dividend account as a result of the deemed disposition under subsection 149(10) will not be available to the corporation should it wish to elect to pay out a capital dividend to its members.

4) Whether a particular transfer is a gift for purposes of the Income Tax Act is a question of fact which is best established after a full review of all the relevant circumstances of the transaction. We refer you to the Income Tax Guide P113, “Gifts and Income Tax” as well as to Interpretation Bulletin IT-110R3, “Gifts and Official Donation Receipts.” The term “gift” is not defined in the Income Tax Act, and must be understood according to its common law meaning. In general, a gift is a voluntary transfer of property from a donor, who must freely dispose of his or her property, to a donee, who receives the property with no right, privilege, material benefit or advantage conferred on the donor or any person designated by the donor in exchange for the gift.

When an entity distributes assets or pays amounts to its members these transactions will be characterized differently depending upon the type of entity, and the nature, timing and purpose of the payments. In general, these payments may be considered as shareholder benefits, proceeds of disposition, capital gains, or payment of dividends. In some cases, they may simply be a return of capital contributions, or a refund of membership fees (there must be clear evidence to support this conclusion).Where the entity is a corporation, and it distributes some of its assets to a shareholder or member, otherwise than by the payment of a dividend or a return of capital, this would likely be characterized as a shareholder benefit under subsection 15(1). Please note that the Canada Revenue Agency has taken the view that members of a corporation without share capital may still be considered shareholders for purposes of subsection 15(1).

Where an unincorporated entity distributes some of its assets to a member, the purpose of the payment must be established. In the context of a wind-up, the transfer may be treated as consideration for the disposition by the member of his membership rights, generally viewed by CRA as capital property. The disposition in such a case could result in a capital gain for the member.

If the entity transfers assets to its members, whether by gift or otherwise, which results in any part of its income being thereby distributed, it will no longer meet the conditions for exemption under paragraph 149(1)(l).

Nothing in this letter should be construed as implying that we are confirming that the income of the entity is, or has been at any particular time, exempt from income tax pursuant to paragraph 149(1)(l). Whether the entity is constituted and operated exclusively for any purpose other than profit, with no part of its income payable to or otherwise available for the personal benefit of any member, is a question of fact which must be determined on an ongoing basis.

We trust our comments will be of assistance.

Yours truly,

R. Filion, CA, CPA

Manager

Non-Profit Organizations and Aboriginal Issues

Business and Employment Division

Income Tax Rulings Directorate

Legislative Policy and Regulatory Affairs Branch