

---

**UNIVERSITY OF OTTAWA  
INTRODUCTION TO THE LAW OF CHARITIES AND  
NON-PROFIT ORGANIZATIONS CML 4104A**

**Ottawa – October 19, 2009**

---

**Related Business and Social Enterprise**

---

**By Terrance S. Carter, B.A., LL.B., Trade-mark Agent**

© 2009 Carters Professional Corporation

**CARTERS™.ca**

**Carters Professional Corporation / Société professionnelle Carters**  
Barristers, Solicitors & Trade-mark Agents / Avocats et agents de marques de commerce

Ottawa (613) 235-4774  
Mississauga (905) 306-2791  
Orangeville (519) 942-0001

**Toll Free: 1-877-942-0001**

**www.charitylaw.ca**

---

UNIVERSITY OF OTTAWA  
INTRODUCTION TO THE LAW OF CHARITIES AND  
NON-PROFIT ORGANIZATIONS CML 4104A

Ottawa – October 19, 2009

Related Business and Social Enterprise

By Terrance S. Carter, B.A., LL.B., Trade-mark Agent  
© 2009 Carters Professional Corporation



Carters Professional Corporation / Société professionnelle Carters  
Distribution, distributeur et Trade-mark Agent / Distributeur et Agente de marques de commerce

Ottawa, Mississauga, Orangeville  
Toll Free: 1-877-942-0001

www.charitylaw.ca  
www.carters.ca

---

---

---

---

---

---

---

---

---

---

INTRODUCTION AND OVERVIEW

- Overview of the challenges within the current Canadian tax regime in facilitating social enterprise
- What is “social enterprise”?
- Challenges faced by social enterprise in Canada
- Lessons from other jurisdictions
- Towards a new paradigm in Canada
- For more information see the paper entitled “Business Activities and Social Enterprise: Towards a New Paradigm” at <http://www.carters.ca/pub/article/charity/2009/tsctlm0507.pdf>

---

---

---

---

---

---

---

---

---

---

A. SOCIAL ENTERPRISE – THE HORIZON

1. What is Social Enterprise?

- In its most basic form, social enterprise is :
  - A business dedicated to a social mission, or
  - Making a profit to achieve a social good
- Social enterprise is sometimes referred to as the “fourth sector”
- Combines charitable missions, corporate methods, and social and environmental consciousness in ways that transcend traditional business and philanthropy

---

---

---

---

---

---

---

---

---

---

- **Social entrepreneurship is the work of a social entrepreneur**
- **A social entrepreneur is someone who recognizes a social problem and uses entrepreneurial principles to organize, create, and manage a venture to make social change**
- **A social entrepreneur assesses success in terms of the impact he/she has on society, rather than measuring performance in profit and return**
- **Social entrepreneurs often work through nonprofits and citizen groups, but they may also work in the private and governmental sectors**

4

---

---

---

---

---

---

---

---

- 2. Social Enterprise in Canada**
- **In Canada, there has been a significant rise in interest in developing social enterprise**
  - **Charities and non-profits have been looking for new ways to replace diminishing funding, diversifying their funding base and improve organizational sustainability**

5

---

---

---

---

---

---

---

---

- **There has been a rise in the inter-relationship between charities and business entities in Canada:**
  - **Charities that are attempting to run in a more “business-like” manner**
  - **Charities that are developing revenue streams through increased sales of goods and services**
  - **Charities that are joining forces with businesses to undertake joint marketing initiatives and cross promotions**

6

---

---

---

---

---

---

---

---

**B. THE CHALLENGE FACED BY SOCIAL ENTERPRISES IN CANADA**

“What we need in addition to conventional charitable giving is a new way to think about philanthropy and the achievement of social goals. ...The business entrepreneur improves our quality of life by creating wealth and economic growth. The social entrepreneur improves our quality of life by confronting the inequality that is often the collateral occurrence of free markets. Both kinds of entrepreneurs are necessary. Let us give them both the chance to succeed.”

*The Right Honourable Paul Martin  
Former Prime Minister of Canada*

---

---

---

---

---

---

---

---

- Although registered charities may conduct limited aspects of social enterprise, what is permitted is very restrictive and falls short of the broad “social enterprise” activities that are being conducted across the global landscape
- CRA documents that speak to this issue
  - CRA’s Guide RC4143(E) “Community Economic Development Programs” available at: <http://www.cra-arc.gc.ca/E/pub/tg/rc4143/README.html>
  - CRA’s policy statement CPS-019 “What is a Related Business?” available at: <http://www.cra-arc.gc.ca/tx/chrts/plcy/cps/cps-019-eng.html>

---

---

---

---

---

---

---

---

- The problem: three separate categories of sectors in the *Income Tax Act (ITA)*:
  - Taxpaying corporations and individuals
  - Tax-exempt non-profits
  - Charities
- However, social enterprise does not fit easily within any of the three existing categories and there are advantages and disadvantages with regard to all three categories

---

---

---

---

---

---

---

---

**1. Operating a Social Enterprise Through a Registered Charity**

**a) Restrictions under the ITA**

- All three categories of charities (charitable organizations, public foundations and private foundations) are prohibited from carrying on any unrelated business
- Charitable organizations and public foundations can carry on related businesses
- For related business restrictions to apply, the activity must be a “business” and the charity must be “carrying on” that business activity

10

---

---

---

---

---

---

---

---

**i. Activities that are not “business activities”**

- Some activities are not “businesses,” even though the charity involved may receive revenue from such activities
- CRA’s policy on “related business” is in relation to a “business” that involves a commercial activity undertaken with the intention to earn profit and the charity derives revenues from providing goods and services

11

---

---

---

---

---

---

---

---

**• Factors used by CRA to determine whether an activity is a “business”**

- Whether the rationale for operating an activity is to generate a profit
- Whether the activity is structured so that it is capable of earning a profit
- Whether the activity earned a profit in the past
- Whether the person or organization that is undertaking the activity has been selected for the position because of commercial knowledge, skill, or experience

12

---

---

---

---

---

---

---

---

- **Examples of income generating activities that are not commercial activities**
  - Soliciting donations
  - Selling donated property
  - Charging fees for providing charitable programs, such as rent from low-income housing programs
  - Community economic development programs (e.g. training businesses, social businesses to address the need of the disabled, and micro-enterprises)

13

---

---

---

---

---

---

---

---

- **Presence of fees do not necessarily mean that a program is non-charitable**
  - Program must maintain two essential characteristics
    - Altruism
    - Public Benefit
  - Factors that the CRA will consider
    - Fee structure is on a “cost-recovery” basis
    - Not offering services comparable to those available in the market place
    - Fees are set according to a charitable objective as opposed to the market place

14

---

---

---

---

---

---

---

---

- ii. **Activities that do not amount to “carrying on” business activities**
  - At common law, “carrying on” implies continuing activity
  - A charity may engage in occasional business activities as long as they are not conducted in a continuing nature
  - Examples of activities that do not constitute the “carrying on” of a business
    - Sponsorship and fundraising
    - Passive investments

15

---

---

---

---

---

---

---

---

- **Most fundraising activities are “business activities”**
  - **However, would not amount to carrying on a business, considering that a fundraising event has a clear “start” and “end” date**
  - **Fundraising event cannot recur with such regularity and frequency that it amounts to carrying on a business**
- **Permissible to derive income from appropriate passive investments**
  - **But must manage them prudently**

16

---

---

---

---

---

---

---

---

- **However, holding an interest in a partnership is considered to be carrying on a business**
  - **Under the laws governing partnerships, the partner carrying on the business is treated as the agent of the partner providing the financing**
  - **An investment by a private foundation in a partnership may be grounds for revocation**

17

---

---

---

---

---

---

---

---

- iii. Related business activities**
- **Charitable organizations and public foundations may carry on related businesses**
  - **Private foundations cannot carry on any business activities**
  - **If non-compliance for unrelated business**
    - **Penalty of 5% of gross revenue from the activity on first offence**
    - **Repeat offence in 5 years: 100% penalty and suspension of receipting privileges**
    - **Revocation of charitable status**

18

---

---

---

---

---

---

---

---

- A related business must be either:
  - Substantially run by volunteers (90%); or
  - Linked and subordinate to a charity’s purpose
- “Related business” is defined in the ITA to “include” a business that is unrelated to the objects of the charity if it is run substantially (90%) by volunteers
  - Based on head count
  - People “employed” means the people the charity uses to operate the business
  - Includes those working for the charity under contract as well as the charity’s direct employees

---

---

---

---

---

---

---

---

- Therefore, as long as the business is run by volunteers, the charity can engage in most types of business activity, regardless of scale
- Four forms of linkage
  - A usual and necessary concomitant of charitable programs
    - Business activities that supplement a charity’s charitable programs
    - e.g. Hospital parking lots, cafeterias, gift shops, university book stores, student residences

---

---

---

---

---

---

---

---

- An off-shoot of a charitable program
  - Charity may create an asset it can exploit in a business in the ordinary operation of charitable programs
  - e.g. Church selling recording of special Christmas services hosted by its famous choir
- A use of excess capacity
  - Gain income during the periods when assets and staff are not being used to full capacity
  - e.g. University renting out residence facilities in summer months

---

---

---

---

---

---

---

---



- Sale of items that promote the charity or its objects
  - Involves sales that are intended to advertise, promote, or symbolize the charity or its objects
  - Product may serve promotional purpose by virtue of design, packaging, or included materials
  - e.g. sale of pens, credit cards, and cookies that clearly display the charity's name or logo, and T-shirts or posters

22

---

---

---

---

---

---

---

---

- Factors of subordination to a charity's purpose
  - The business activity receives a minor portion of the charity's attention and resources
  - The business is integrated into the charity's operations (not acting as a self-contained unit)
  - The charity's charitable goals continue to dominate its decision-making
  - The charity continues to operate for an exclusively charitable purpose, not permitting any private benefit

23

---

---

---

---

---

---

---

---

- iv. Other limitations
- Legal structure
    - A registered charity cannot be organized as a partnership
    - If a charity is a partner in a partnership, it is generally recognized to be carrying on a business
  - Disbursement quota
    - Expenditure on operating a business activity or a fundraising activity do not count toward meeting the disbursement quota

24

---

---

---

---

---

---

---

---

- **Restrictions on foundations with regard to business activities:**
  - **Public and private foundations cannot incur debt, other than for current operating expenses, purchase and sale of investment and administration of charitable activities**
  - **Public and private foundations cannot acquire more than 50% of a corporation’s issued share capital with full voting rights, however shares may be gifted to a foundation (regardless of the percentage) as long as the foundation does not acquire more than 5% of the shares for consideration**

25

---

---

---

---

---

---

---

---

- **Private foundations cannot engage in any business activities**
- **Private foundations are subject to excess corporate holding rules requiring – public disclosure over 2% and divestment over 20%**
- **Restriction on fundraising**
  - **Necessary to see whether what is intended to be a business activity may be a fundraising activity and subject to CRA’s new fundraising policy**

26

---

---

---

---

---

---

---

---

**b) Restrictions under provincial statutes**

- **Charitable Gifts Act (Ontario) - restrictions on charities owning more than a 10% “interest in a business”**
  - **If charity owns more than 10% of the shares of a business, it must dispose of any interest in excess of 10% within 7 years, although can obtain a court order to extend 7 year period**
  - **Where ownership exceeds 50%, Act requires financial statements to be filed with PGT each year**

27

---

---

---

---

---

---

---

---

- The Act provides that the prohibition on owning more than 10% interest does not apply to an organization of any religious denomination
- “Interest in a business” has a problematic statutory definition, vague and broad
- *Trustee Act (Ontario)* - establishes a prudent investment standard
  - s. 27 states trustee “must exercise the care, skill, diligence and judgment that a prudent investor would exercise in making investments”

---

---

---

---

---

---

---

---

- *Charities Accounting Act (Ontario)* - restrictions on a charity holding property for more than three years if it is not used or required to be used for its charitable purpose
  - If non-compliance, PGT may vest the property in itself, sell the property and use the proceeds of the sale for the charitable purposes of the charity in question
  - However, PGT administratively permits non-charitable and incidental use of land so long as space is generally less than 20% of the total area

---

---

---

---

---

---

---

---

c) Restrictions at common law

- Charities in Ontario cannot pay directors any form of remuneration for service rendered without court approval
  - Directors of charities are considered to have trustee-like fiduciary obligations placed on them in relation to charitable property
- Directors of charities have a duty to avoid a conflict of interest

---

---

---

---

---

---

---

---

**2. Operating a social enterprise through a registered charity and intermediary entities**

- **Charities have utilized intermediary entities as a means to carry on business activities that would otherwise not be permissible to be conducted by the charities themselves**
  - **For-profit companies**
  - **Non-profit corporations**
  - **Business trusts**
  - **A combination of these entities**

31

---

---

---

---

---

---

---

---

**a) For-profit company as intermediary**

- **A registered charity incorporates a for-profit business share capital corporation as an intermediary to operate the business or own revenue generating real property**
- **An arrangement would then be made in relation to the shareholdings of the for-profit company so that the charity would maintain control or influence over the shareholders**

32

---

---

---

---

---

---

---

---

- **If the for-profit was to hold title to a revenue generating real property, option would allow the charity to avoid 3-year limitation under *Charities Accounting Act (Ontario)* for charities**
- **Profits earned may be paid to the charity as donations from pre-tax profits, reducing tax liability of the for-profit corporation, and after tax profits can be paid as dividends**
- **However, there are a number of concerns as listed below**

33

---

---

---

---

---

---

---

---

**i. Tax liability under ITA**

- Tax would have to be paid on taxable income (but may claim a deduction for donations up to 75% of the company's net income)
- Management service fees and sponsorship fees may also be provided by the charity in return for fair market compensation to be paid by the business
- Actual tax on placing unrelated business activity in a wholly-owned for profit subsidiary may be as low as 3% to 5% in some instances

34

---

---

---

---

---

---

---

---

**ii. Interest in business - *Charitable Gifts Act* (Ontario)**

- Charities cannot own more than a 10% "interest in a business"
- Charity must either wind up or dispose of its interest in excess of 10% in the for-profit company within 7 years
- If a charity owns more than 50% interest, it will have to make annual disclosure to the Public Guardian and Trustee

35

---

---

---

---

---

---

---

---

**iii. Foundation not able to control a corporation**

- Charitable foundations cannot control a corporation

**iv. Governance and liability issues**

- Needs to consider appropriate governance issues involving the for-profit company
- e.g., who would act as directors and shareholders for the for-profit company?
- e.g., the closer the relationship between the two entities, the greater the possibility of cross-over liability

36

---

---

---

---

---

---

---

---

**b) A non-profit organization as intermediary**

- Registered charity incorporates a non-share capital corporation that would be a tax-exempt “non-profit organization” (“NPO”) as an intermediary to operate the business activity
- May be appropriate in some circumstances, e.g. by holding title to an income generating real property
- The application may be limited, since there are limitations on NPOs to carry on business to earn profit

37

---

---

---

---

---

---

---

---

**c) A combination of a for-profit company and a non-profit corporation as intermediary**

- A for-profit company would be incorporated to operate the business activity, and 100% of the shares would be owned by an NPO
- In Ontario, this may overcome limitations placed by *Charitable Gifts Act*
- An NPO can derive income from a taxable entity
- Possible for an NPO to hold shares of a wholly-owned for-profit corporation

38

---

---

---

---

---

---

---

---

**d) A business trust as intermediary**

- The trust would operate the business activity and the charity would become an income beneficiary of the trust, with the income earned by the trust to be distributed to the charity as an income beneficiary
- Trusts are taxable, but income that is distributed by the trust to the charity as an income beneficiary would not be subject to tax
- Pre-tax profits of trust can be distributed to any beneficiary, regardless of whether they are taxable or non-taxable, as such, a trust arrangement can be used to bring in other parties to participate in a business venture

39

---

---

---

---

---

---

---

---

- However, not entirely clear whether this option would avoid the application of the *Charitable Gifts Act*
- It may be possible to use a combination of a business trust and a for-profit company
  - For-profit would operate the business
  - Trust would hold 100% of the shares
  - Charity would benefit from the income of the trust
    - However, same concerns regarding application of *Charitable Gifts Act*

---

---

---

---

---

---

---

---

- Various other concerns:
  - The trust would need to pay income tax every 21 years due to a deemed disposition
  - Rule against perpetuity
  - The business trust would be subject to applicable provincial trustee legislation
  - The need for appropriate relational mechanisms involving the trust in order to avoid cross-over liability

---

---

---

---

---

---

---

---

3. Operating a Social Enterprise Through Other Forms of Entities and Foregoing Charitable Status

a) Operating through a for-profit company

- Advantages
  - No restriction on related business
  - Can pay directors
  - Restrictive provincial statutes do not apply
  - Can attract equity investment

---

---

---

---

---

---

---

---

- **Disadvantages**
  - **Cannot issue donation receipts**
  - **Taxable (but can claim charitable credit up to 75% of its net income)**
  - **Can claim deductions from sponsorship and advertising, but must be reasonable in the circumstances**
  - **Charities cannot make program related investments in a business**

43

---

---

---

---

---

---

---

---

- **A for-profit company may also want to establish a parallel foundation to carry out its charitable giving program**
  - **Allows for better coordination of corporate giving programs**
  - **Better public perception than a company's own donation programs**
  - **Elevated public image of the company being fiscally or corporately responsible**
  - **Builds an asset base for consistent long-term charitable giving even when corporate profits are down**

44

---

---

---

---

---

---

---

---

- b) Operating through a non-profit corporation**
- **Advantages**
    - **Generally tax-exempt**
    - **Related business policy does not apply**
    - **Can pay directors**
    - **Restrictive provincial statutes do not apply**

45

---

---

---

---

---

---

---

---



- **Disadvantages**
  - **Must not otherwise be a charity**
  - **Cannot issue donation receipts**
  - **Cannot be organized or operated to make a profit**
  - **No income to its members**
  - **Cannot accumulate excess funds each year beyond its reasonable needs**
  - **If NPO status is lost, it would become taxable**

46

---

---

---

---

---

---

---

---

- **Some key issues affect viability of using an NPO for social enterprise**
  - **Must operate exclusively for non-profit purposes**
  - **Cannot carry on a trade or business not connected or attributable to its non-profit goals**
  - **Cannot accumulate excess funds beyond the NPO's reasonable needs**
  - **Cannot make any of its income available to its members or shareholders**
    - **Can make reasonable payments, i.e., salaries, wages, fees or honoraria for services**

47

---

---

---

---

---

---

---

---

- C. LESSONS FROM OTHER JURISDICTIONS**
- 1. United Kingdom: Community Interest Company ("CIC")**
- **Limited liability company designed for social enterprise**
  - **Enabling legislation enacted in 2005; now over 2,700 registered CICs**
  - **Can be established for any lawful purpose, as long as their activities are carried on for the benefit of the community (charities must be established exclusively for charitable purposes)**

48

---

---

---

---

---

---

---

---

- Can issue shares to raise capital and pay dividends subject to a cap
- Directors can be paid
- Subject to a “community interest test” - whether a reasonable person considers that its activities are carried on for the benefit of the community
- Subject to asset lock to ensure that the assets of the CIC are used for community purposes
- CIC are taxable entities

49

---

---

---

---

---

---

---

---

2. **United States: Low-profit Limited Liability Company (“L3C”)**
- Enabling legislation first passed in Vermont on April 30, 2008
  - Since then, has developed in other states (e.g. Michigan, North Dakota, Utah, Illinois and Wyoming) and pending in others (e.g. Arkansas, Missouri, North Carolina and Tennessee)

50

---

---

---

---

---

---

---

---

- Designated as low-profit limited liability company with charitable or educational goals
- Primarily designed to attract program-related investments from private foundations in the U.S.
- Investments in an L3C are not deductible
- Not exempt from taxation but income and expense of a L3C are allocated among the members of the L3C, reported on their returns and taxed in their hands

51

---

---

---

---

---

---

---

---

**D. TOWARDS A NEW PARADIGM IN CANADA**

- Current Canadian regulatory regime for registered charities is very restrictive of their ability to engage in business activity, let alone social enterprise
- Not possible to predict what a Canadian model might look like, but there is a clear need to develop Canada’s solution to empower the social enterprise option
- Some factors that might be considered in developing a Canadian social enterprise option could include:

52

---

---

---

---

---

---

---

---

- The creation of a new corporate hybrid vehicle to draw upon the best of the U.S. & U.K. legislation, e.g. a new federal *Community Enterprise Act*
- An alternative might be to allow entities to be incorporated under existing corporate legislation and provide other attractive features, such as some form of tax exemption
- The hybrid would need to facilitate the raising of capital by issuing shares (but also need a mechanism to keep track of missing shareholders)

53

---

---

---

---

---

---

---

---

- Possibly to provide tax incentives for investment, such as tax credits or deductions for investors
- Possibly permit charities to “invest” in social enterprise entities, with such investment to be counted toward their disbursement quota
- Possibly to impose an asset lock and the capping of the return of investments at a certain level in order to ensure focus is on social purpose instead of profit

54

---

---

---

---

---

---

---

---

- Possibly need a registration system for the hybrid
- Possibly provide tax treatment to the hybrid, ranging from full or partial tax-exemption
- Possibly coordinate changes to other federal and provincial legislative

**DISCLAIMER**

This handout is provided as an information service by Carters Professional Corporation. It is current only as of the date of the handout and does not reflect subsequent changes in the law. This handout is distributed with the understanding that it does not constitute legal advice or establish a solicitor/client relationship by way of any information contained herein. The contents are intended for general information purposes only and under no circumstances can be relied upon for legal decision-making. Readers are advised to consult with a qualified lawyer and obtain a written opinion concerning the specifics of their particular situation.

© 2009 Carters Professional Corporation