OVERVIEW

• Introduction
• Operating a social enterprise through a registered charity – including as a related business
• Operating a social enterprise through a registered charity and intermediary entities
• 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. INTRODUCTION: SOCIAL ENTERPRISE IN CANADA

• In its most basic form, social enterprise is a business dedicated to a social mission or making a profit to achieve a social good
• Combines charitable missions, corporate methods, and social and environmental consciousness in ways that transcend traditional business and philanthropy
• 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
• 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

Challenge Faced By Social Enterprises In 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’s policy statement CPS-019 “What is a Related Business?”

• Social enterprise in Canada is carried out through a variety of legal vehicles:
  – Through a registered charity
  – Operating through a registered charity and intermediary entities
  – Operating through other forms of entities and foregoing charitable status, e.g.,
    ▪ Taxpaying corporations, entrepreneurs or partnerships
    ▪ Tax-exempt non-profits
    ▪ Co-operatives
B. OPERATING A SOCIAL ENTERPRISE THROUGH A REGISTERED CHARITY

1. Restrictions Under the ITA

- CRA's CPS-019 “What is a Related Business

- 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

- Related business restrictions apply if the activity is a “business” and the charity must be “carrying on” that business activity

a) 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

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

  - Intended course of action - Whether the rationale for operating an activity is to generate a profit

  - Potential to earn a profit - Whether the activity is structured so that it is capable of earning a profit

  - Profits in past years - Whether the activity earned a profit in the past

  - Experience and expertise of management - Whether the person or organization that is undertaking the activity has been selected for the position because of commercial knowledge, skill, or experience
A charity may engage in occasional business activities as long as they are not conducted in a continuing nature.

Examples of income generating activities that are not commercial activities:
- Soliciting donations
- Selling donated goods

Presence of fees do not necessarily mean that a program is a business.
- Program must indicate altruism and 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.
- Examples:
  - Charging rent from low-income housing programs, university tuition fees
  - Community economic development programs (e.g., training businesses, social businesses)

Activities that do not amount to "carrying on" business activities:
- At common law, "carrying on" implies continuous or regular operation.
- 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
Most fundraising activities are "business activities", but would not amount to "carrying on"

- Has a clear "start" and "end" date
- Does not recur with high regularity and frequency
- However, holding an interest in a partnership is carrying on a business
  - Under the laws governing partnerships, the partner carrying on the business (general partner) is treated as the agent of the partner providing the financing (limited partner)
  - An investment by a private foundation in a partnership may be grounds for revocation

Related business activities

- Charitable organizations and public foundations may carry on related businesses
- Private foundations cannot carry on any business activities
- If non-compliance
  - 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

Two types of related businesses:

- Substantially run by volunteers (90%) (based on a head count)
- 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 both employees and independent contractors
- 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
- An offshoot of a charitable program
- A use of excess capacity
- Sale of items that promote the charity or its objects

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 offshoot 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
- 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
- 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

- 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

- 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
22. 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 fundraising policy

23. 2. Restrictions Under Provincial Statutes
   • Trustee legislation – e.g., Trustee Act (Ontario) – establishes a prudent investment standard

3. 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

24. C. 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
• Relationship Considerations
  – Separation needed to protect the charity's assets cannot be used to benefit the intermediary (concept of “financial firewall”)
  – Separate boards or at least a situation in which charity’s board is not controlled by board of non-charity
  – Distinctive names to avoid confusion
  – Separate equipment, personnel and space
  – Legal agreements where necessary

1. 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
• However, there are a number of concerns

a) 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
b) Foundation not able to control a corporation
   – Charitable foundations cannot control a corporation

c) 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?

d) Relationship issues
   – Will the charity provide services or resources to the business/provide loan for security?

2. 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
   • The application may be limited, since there are limitations on NPOs to carry on business to earn profit
   • Similar issues to consider re: governance and relationship as in business corporation example

3. 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
   • Possible for an NPO to hold shares of a wholly-owned for-profit corporation
4. 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

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
- Unfamiliarity in Canada with legal form

Disclaimer

This powerpoint 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.

© 2012 Carters Professional Corporation