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Going into Business? The Social Enterprise Spectrum for Charities

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**The 2016 Ottawa Region
Charity & Not-for-Profit Law
Seminar**

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Spectrum for Charities**

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OVERVIEW OF TOPICS

- Why “Going into Business” matters for Charities
- The Social Enterprise Paradigm for Charities
- Understanding What “Business” Means in a Charitable Context
- Business Sources of Income Generation
- Charitable Sources of Income Generation




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A. WHY “GOING INTO BUSINESS” MATTERS FOR CHARITIES


- Many charities will, at one time or another, look for other sources of income to supplement income
- Charities, though, will generally want their income-producing programs and activities to be tied to achieving their charitable purposes
- In essence, charities want to feel good when they are seeking to “make a dollar”




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- In this regard, many charities may think in terms of undertaking a “social enterprise” when they think of embarking on a business activity to generate income 
- However, there is much confusion about what constitutes a “social enterprise” and what types of business activities charities can become involved with
- The “devil is in the details” applies to this topic



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B. THE “SOCIAL ENTERPRISE” PARADIGM FOR CHARITIES


- In its most basic form, “social enterprise” can be boiled down to mean:
 - a business dedicated to achieving a social mission, or
 - making a profit to achieve a social good
- A “social enterprise” is not expected to provide a significant return to its investors since the focus is on achieving a social good instead of a profit
- Social enterprises combine charitable missions, corporate methods, and social consciousness in ways that transcend traditional business and philanthropy

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- The ongoing public interest in “social enterprise” in Canada is reflected in the introduction of new provincial social enterprise legislation:
 - B.C. - Community Contribution Companies
 - Nova Scotia - Community Interest Companies
 - Ontario is looking at the possibility of dual purpose legislation
- However, social enterprise corporations are taxable companies with no tax incentives available for investors



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- Charities, though, enjoy tax advantages in being exempt and can issue tax receipts
- Charities provide a public benefit in pursuing their charitable purposes
- The conundrum for charities is to be able to fulfill their charitable purposes through “social enterprise” while still being compliant with the *Income Tax Act* (ITA)
- It is therefore important to understand:
 - what “business” means in a charitable context, and
 - what business and other income-generating activities charities can and cannot be involved with

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C. UNDERSTANDING WHAT “BUSINESS” MEANS IN A CHARITABLE CONTEXT

- At common law, as reinforced by the ITA, charities must have exclusively charitable purposes
- CRA states that running a business for a charity cannot become a purpose in its own right - it must remain subordinate to the organization’s charitable purpose
- Under the ITA, registered charities can lose their charitable registration if they carry on an “unrelated business” i.e. a business that is not a “related business” as defined under the ITA

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- With the exception of private foundations, charities can carry on “related business” activities, as explained below
- It is first necessary to understand what is considered a “business activity” in a charitable context
- CRA Policy Statement on Related Business Activities (CPS-019) defines “business” as a commercial activity deriving revenues from providing goods or services, undertaken with the intention to earn profit



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- Factors identified by CRA in determining whether an activity is a “business” include:
 - 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 undertaking the activity has been selected because of commercial knowledge, skill, or experience



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- CRA examples of income-generating activities that are not considered a business:
 - Soliciting donations
 - Selling donated property, if not done continuously
 - Charging fees in providing charitable programs, such as rent from low-income housing programs
 - Community economic development programs e.g. training businesses, social businesses to address the needs of the disabled, and micro-enterprises



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- CRA examples of indicators that income generating activity is not a business:
 - The fee structure is to defray the costs of the program rather than to make a profit
 - The program does not offer services comparable to those in the marketplace
 - The fees are set according to charitable objectives as opposed to market objectives, e.g. rent reflecting tenants’ financial means
- A charity may engage in occasional business activities provided such activities are not operated regularly or continuously

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- Examples of activities not considered by CRA to constitute the “carrying on” of a business:
 - Fundraising and sponsorship
 - Passive investments
- There are therefore income-generating opportunities for charities that involve business activities and those that do not
- Need to look at business sources of income generation, as well as other sources of income generation that make up the “social enterprise” spectrum for charities

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The Social Enterprise Spectrum for Charities

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D. BUSINESS SOURCES OF INCOME GENERATION

1. “Related Business” Income

- The ITA permits charitable organizations and public foundations to carry on “related businesses” as described below
- However, private foundations cannot carry on any “related business” activities
- With a “related business,” there is no requirement that the charity price the product or service on a cost recovery basis, so it is permissible to make a profit

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- Non-compliance resulting from engaging in businesses that are not “related business” can result in:
 - Penalty of 5% of gross revenue from the activity on first offence
 - Repeat offence in 5 years: 100% penalty and suspension of receipting
 - Revocation of charitable status
- A “related business” as defined under the ITA is a business that is either:
 - Substantially run by volunteers (90%); or
 - Linked and subordinate to a charity’s purpose

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(a) “Related Business” Substantially Run By Volunteers

- “Related business” is defined in the ITA to include a business that is unrelated to the objects of the charity, provided that it is run substantially (90%) by volunteers
 - 90% volunteer determination is based on a head count as opposed to a time equivalent calculation
 - e.g. calculation is based on the number of people used to operate the business, not the number of hours worked
 - A business run by 90% volunteers can be unrelated to the charitable purpose and focus on profit (like a PEI church lobster dinner)

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(b) “Related Business” that is Linked and Subordinate to Charitable Purposes

- Four forms of linkage identified by CRA:
 - 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

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- 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 recordings of special Christmas services hosted by its famous choir
- A use of excess capacity
 - Earn 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



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- 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



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- Factors that indicate subordination to the charitable purpose:
 - The business receives a minor portion of the charity's attention and resources
 - The business is integrated into the charity's operation (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 by permitting no element of undue private benefit to enter into its operations

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2. "Unrelated Business" Income Through a For-Profit Subsidiary


- In order to avoid the charity carrying on an "unrelated business" and possible penalties and/or revocation, a charity might consider incorporating a for-profit corporation to act as an intermediary to operate the "unrelated business"
- A subsidiary corporation could also be effective in containing liability within the for-profit corporation
- However, in doing so, there are a number of factors that would need to be considered as listed below:

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(a) Tax liability under ITA

- Tax would have to be paid on income (but may claim a deduction for donations up to 75% of net income)
- As well, management service fees and sponsorship fees may be charged by the charity to reduce taxable net income
- Resulting tax consequences of placing "unrelated business" activity in a for-profit subsidiary could be as low as 4% to 6% in some instances, depending on the circumstances




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(b) Charity Owning an Interest in a Business

- Having a charity acquire an interest in a for-profit corporation was previously restricted because of the *Charitable Gifts Act* before it was repealed in 2009
- The issue is now whether owning an interest in a for-profit corporation is a prudent investment under the *Trustee Act*



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(c) Restrictions on Foundations Owning a For-Profit Business Corporation:

- Public and private foundations cannot acquire more than 50% of 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
- Private foundations are subject to excess corporate holding rules requiring public disclosure over 2% and divestment requirements over 20%

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3. “Unrelated Business” Income Through a NPO?

- Is it possible to run an “unrelated business” through a not-for-profit corporation that claims status as a non-profit organization (NPO) under the ITA?
- The answer is generally no, because a NPO must be organized and operated for any purpose other than for profit
- While incidental or unanticipated profit may be possible, a motivation to earn a profit is not an option for a NPO

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E. CHARITABLE SOURCES OF INCOME GENERATION



- The following are examples of other income generation options by a charity that constitute a form of “social enterprise,” e.g. “making a profit to advance a social good”
- Income generating charitable programs described below would meet the 3.5% disbursement quota of the charity but not program related investments or loans
- See CRA Guidance (CG-014) on Community Economic Development Activities (CED Guidance) for details

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1. Examples of Income Generating Charitable Programs

(a) Social Businesses for the Disabled

- CRA explains in its CED Guidance that the definition of “disability” means a previous or existing mental or physical disability, and includes disfigurements and previous or existing dependence on alcohol and drugs
- Social businesses involving those with disabilities seek to provide permanent employment, not simply on-the-job training or limited time employment

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- Social businesses for the disabled may provide services, sell goods, manufacture articles, operate retail outlets or undertake other kinds of work
- Social businesses for the disabled must employ only individuals with disabilities, except for training staff
- Work must match the special needs of individuals with disabilities
- CRA does not prohibit these businesses from earning a profit, so long as the focus is on helping eligible beneficiaries

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(b) Employment Related Training for the Unemployed


- The CED Guidance provides that employment-related training activities that relieve unemployment can be charitable provided the beneficiary group consists of individuals who are:
 - unemployed or facing a real prospect of imminent unemployment, and
 - are shown to need assistance (i.e. lack of resources or skills to help themselves)



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- Examples of employment-related training:
 - Employability training: developing skills such as English and French language instruction, or life skills, such as time management
 - Entrepreneurial training: providing instruction on preparing a business plan, preparing financial statements, etc.
 - On-the-job training: providing on-the-job training in vocational or work skills that enhance employability
- CRA permits charities to generate incidental profits from these programs



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(c) Low Rent Housing


- CRA in its Guidance on Housing and Charitable Registration (CG-022) explains that low income rental housing can be charitable if it relieves poverty or helps in managing conditions associated with disability or age
- The charity must assess the eligibility of its beneficiaries at least annually (based on their income, assets and liabilities)
- If beneficiaries are ineligible, the rent must:
 - qualify as investment property generating a fair market value return, or
 - meet the “related business” provisions of the ITA

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(d) Sales of Goods and Services

- CRA Guidance on Fundraising (CG-013) states that the sale of goods and services will be seen as charitable if:
 - it serves the charity’s beneficiaries
 - directly furthers a charitable purpose, and
 - they are sold on a cost-recovery basis
- For example, university tuition, sale of religious literature by a church, and tickets sold by a symphony




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2. Micro-loans and Loan Guarantees


- The CED Guidance (CG-014) expands the ability of charities to provide loans to achieve a charitable purpose, including micro-loans and loan guarantees
- Charities can operate these programs to advance education or other charitable purposes that benefit the community, not just to relieve poverty
- E.g. loan guarantees to help eligible beneficiaries attend courses to enhance their employability or establish a business



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- Providing start-up loans and loan guarantees to establish businesses for an eligible beneficiary can be charitable
 - However, must further a charitable purpose, not simply promote entrepreneurship
 - Loans should generally be under \$10,000
- Generally, interest rates should be at or below fair market value, but exceptions may be justifiable, e.g.
 - Terms of the loan permit the borrower to delay repayment, or
 - If there is a high loan-loss ratio



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3. Program-related Investments (PRIs)

(a) What are PRIs?


- PRIs are investments that directly further the charitable purposes of the charity
- PRIs are not investments in the conventional sense because, while PRIs may generate a return of capital, they are not made for that reason
- As such, PRIs are not required to generate a return of capital for the charity or yield interest
- Charities are also now allowed to conduct PRIs with non-qualified donees

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(b) Types of PRIs


- Loans and loan guarantees - to another organization to allow the other organization to achieve the charitable purpose of the investor charity, e.g. making a loan to a third party so that the third party can acquire job training equipment for eligible beneficiaries
- Leasing land and buildings - buying a building and leasing it to an organization to accomplish a charitable purpose, e.g. for education purposes



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- Share purchases - a charity can now purchase shares in a for-profit company to accomplish their charitable purpose, e.g. operating an apartment complex for the poor
 - However, public and private foundations cannot acquire a controlling interest in a company
 - Private foundations are also subject to other restrictions, such as divestment obligations for shareholdings above 20%, under the excess corporate holding regime




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(c) Requirements of charities engaging in PRIs

- Charities conducting PRIs must have:
 - A policy describing how the charity will make decisions regarding PRIs
 - Documentation explaining how each PRI furthers its charitable purpose
 - Exit mechanisms to withdraw from a PRI or convert it to a regular investment if it no longer meets the charity's charitable purpose
- Evidence of direction and control over PRIs to non-qualified donees



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