
**CSIED
SOCIAL ENTERPRISE SEMINAR**

Ottawa – May 27, 2010

**Social Enterprise in Canada:
Towards a New Paradigm**

By Jane Burke-Robertson

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A. SOCIAL ENTERPRISE – OVERVIEW

1. What is Social Enterprise?

- “...in its most basic form, a social enterprise is a business dedicated to a social mission...” [S. Gould]
- “Social enterprise is an organization or venture that achieves its primary social or environmental mission using business methods.” [Social Enterprise Alliance, Washington D.C.]
- Social enterprise is sometimes referred to as the “fourth sector”

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- Social enterprise in Canada is carried out through a variety of legal forms:
 - Sole proprietorship or partnership registered provincially
 - Business corporation
 - Co-operative
 - Non-profit corporation
 - Registered charity engaging in “related business”, training or social business
 - A non-profit or charity that owns a for-profit business or carries on a joint venture

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- **Charities and Non-Profit Organizations**
 - All charities are non-profit organizations but not all non-profit organizations are charities
 - Being a registered charity means that the organization is:
 - Exempt from tax
 - Able to issue donation receipts
 - Able to receive grants from other registered charities

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- Good housekeeping “seal of approval”
- Otherwise little reason to be a registered charity in view of the administrative burden on charities under the ITA
- Has been said that becoming a registered charity is a “one-way street”

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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 improving organizational sustainability

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- 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

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B. THE CHALLENGE FACED BY SOCIAL ENTERPRISES IN CANADA

- 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

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- 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 Guide RC4143(E) “Community Economic Development Programs”
- CRA’s policy statement CPS-019 “What is a Related Business?”

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This presentation will review:

1. Operating a social enterprise through a registered charity
2. Operating a social enterprise through a registered charity but using an intermediary
3. Operating a social enterprise using other forms of legal structure

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1. Operating a Social Enterprise Through a Registered Charity [CPS-019 "What is a Related Business"]

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 (not privates)
- Related business restrictions apply if the activity is a "business" and the charity is "carrying on" that business activity

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• 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

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- A charity may engage in occasional business activities as long as they are not conducted in a continuing nature
- Examples of activities that CRA does not consider to constitute the “carrying on” of a business
 - Soliciting donations
 - Sponsorship and fundraising
 - Passive investments

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- CRA does not consider to be business activities:
 - 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)

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- ‘Training businesses’ and ‘social businesses’ are viewed by CRA as charitable activities
- ‘Training businesses’ – purpose is to give on-the-job training in vocational skills or more general training in work skills that enhances a person’s employability. To be charitable, the dominant purpose cannot be simply to provide people with employment

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- In a training business, participants are employed only for a limited period of time and revenues derived from the business do not substantially or consistently surpass the break-even point
- ‘Social businesses’ address the needs of the disabled. They seek to provide employment on a permanent basis. The workforce is comprised almost entirely of people who are disabled.

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(b) Related business activities

- “Related business” not defined in ITA
- Charitable organizations and public foundations may carry on related businesses
- If non-compliance
 - Penalty of 5% of gross unrelated business revenue earned in fiscal period (first offence)
 - Repeat offence in 5 years: 100% of gross unrelated business revenue earned in fiscal period and suspension of receipting privileges
 - Revocation of charitable status

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- To be considered a “related business”, the business activity must be either:
 - Substantially run by volunteers (90%) (based on a head count):
 - “Linked” and “subordinate” to a charity’s purpose
- Question of fact whether these tests are met
- Note: The fact that profits from a business are applied to a charitable purpose is not sufficient to constitute the necessary linkage

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- “Linked” to a charity’s purpose – one of four forms of linkage:
 - A usual and necessary concomitant of charitable programs (e.g. hospital parking lot)
 - An off-shoot of a charitable program (e.g. church selling recordings)
 - A use of excess capacity (e.g. university residences)
 - Sale of items that promote the charity or its objects (e.g. sale of calendars, t-shirts)

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- “Subordination” to a charity’s purpose (all 4 must apply)
 - 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

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- Other 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, (though shares may be gifted to a foundation)

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(c) Recent legislative changes affecting charities signal positive changes for social enterprise being carried out by charities

- December 15, 2009 – Repeal of the *Charitable Gifts Act*
- 2010 Federal Budget – Elimination of 80/20 DQ for registered charities (previously expenditure on related business activities did not count towards meeting the DQ)

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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

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• Relationship Considerations

- Separation needed to protect the charity - 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

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a) For-profit company as intermediary

- A registered charity incorporates a business corporation as an intermediary to operate the business
- 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 considerations

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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)
- However, 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

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ii. Foundation not able to control a corporation

- Charitable foundations cannot control a corporation

iii. Governance 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?

iv. Relationship issues

- Will the charity provide services or resources to the business/provide loan for security?

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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
- The application may be limited, since there are limitations on NPOs to carry on business to earn profit (discussed later)
- Similar issues to consider re: governance and relationship as in business corporation example

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c) 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

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• Various other concerns:

- The trust would need to pay income tax every 21 years due to a deemed disposition
- The business trust would be subject to applicable provincial trustee legislation
- Unfamiliarity in Canada with legal form

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3. Operating a Social Enterprise through other types of entities and foregoing charitable status

a) Operating through a for-profit company

- **Advantages**
 - No restriction on related business
 - Can pay directors
 - Can attract equity investment

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- **Disadvantages**
 - Cannot issue donation receipts
 - Taxable (but can claim charitable deductions 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
 - May not be eligible for government grants or other public funding

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b) Operating through a non-profit corporation

• **Requirements under paragraph 149(1)(l):**

- Must not be a charity
- Must be organized and operated for any purpose other than profit
- Income cannot be payable to or made available to its members
- **Note:** An organization may qualify for non-profit status under incorporating legislation but not under ITA

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- Advantages of using an NPO
 - Generally tax-exempt
 - Related business policy and other restrictive requirements of ITA relating to charities do not apply
 - Can pay directors for services

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- Disadvantages
 - Cannot issue donation receipts
 - No income to its members
 - Cannot be organized or operated to make a profit
 - Any profit must be unintended and incidental to the purposes of the organization
 - If NPO status lost, it becomes taxable

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- Technical Interpretation 2009-0337311E5 – A changing perspective?
 - Establishes a higher standard for non-profits to meet to avoid taxation on any surplus of income over expenditures
 - “...Where an organization intends, at any time, to earn a profit, it will not be exempt from tax under paragraph 149(1)(l) even if it expects to use or actually uses that profit to support its non-profit objectives”.

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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 3,000 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)

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- 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

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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)

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- 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 member of the L3C, reported on their returns and taxed in their hands

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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
- Some factors that might be considered in developing a Canadian social enterprise option could include:
 - 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*

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- 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)

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- 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

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- 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

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