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**CANADIAN SOCIETY OF  
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TRILLIUM CHAPTER  
7<sup>TH</sup> ANNUAL WINTER SUMMIT**

**GOING INTO BUSINESS?**

**THE SOCIAL ENTERPRISE SPECTRUM  
FOR NPOs AND CHARITIES**


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<p><b>Going into Business?</b> <b>The Social Enterprise Spectrum for NPOs and Charities</b></p> <p>By Terrance S. Carter, B.A. LL.B., TEP, Trade-mark Agent tcarter@carters.ca 1-877-942-0001</p> <p>© 2017 Carters Professional Corporation</p>	
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2	
<p><b>OVERVIEW OF TOPICS</b></p> <ul style="list-style-type: none"><li>• Why “Going into Business” matters for NPOs and Charities</li><li>• The Social Enterprise Spectrum</li><li>• Understanding What “Business” Means</li><li>• Related Business Income for Charities</li><li>• Other Sources of Income Generation for Charities</li><li>• Business Income for NPOs</li><li>• Utilizing a For-Profit Subsidiary to Generate Income</li></ul> 	
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## A. WHY “GOING INTO BUSINESS” MATTERS FOR NPOS AND CHARITIES

- For reference purposes, an “NPO” refers to a “non-profit organization” under par 149(1)(l) of the *Income Tax Act* (ITA)
- Many NPOs and charities look for other sources of income to supplement their regular membership, fundraising and/ or sponsorship income
- NPOs and charities will often want their income-producing programs and activities to be tied into achieving their NPO or charitable purposes



- NPOs and charities generally want to feel good about “making a dollar”
- To do so, many NPOs and charities may think in terms of undertaking a “social enterprise” 
- However, there is much confusion about what constitutes a “social enterprise” and what types of business activities NPOs and charities can become involved with
- The “devil is in the details”  applies to this topic

5

## B.THE “SOCIAL ENTERPRISE” SPECTRUM

- In its most basic form “social enterprise” can be described as:
  - 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 making a profit
- Social enterprises combine charitable/not-for-profit purposes, corporate methods, and social consciousness in ways that transcend business and philanthropy

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6

- 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 social enterprise legislation (dual purpose corporations)
- However, social enterprise corporations are taxable companies with no tax incentives for investors



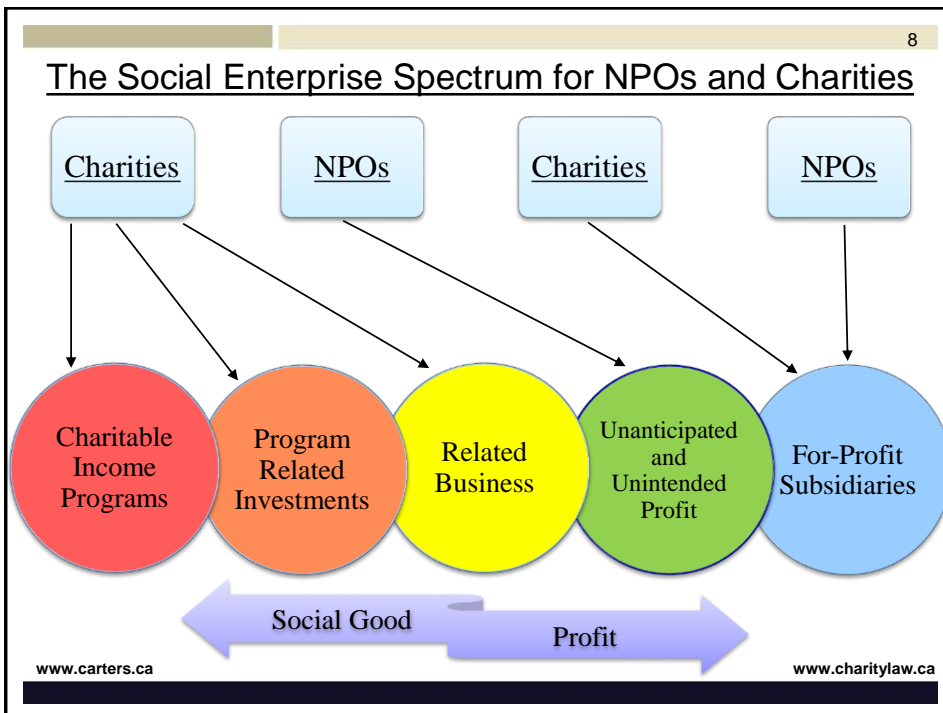
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7

- NPOs, though, are exempt from tax
- Charities are both exempt from tax and can issue charitable receipts for donations
- The challenge for NPOs and charities is to fulfill their respective purposes through a “social enterprise” while still being compliant with tax exempt/charitable status
- It is therefore important to understand:
  - what “business” means
  - what business and other income-generating activities charities and NPOs can do
  - how business incomes fit within the social enterprise spectrum

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## C. WHAT DOES “BUSINESS” MEAN?

- Neither NPOs or charities can have purposes to operate a for-profit business
- An NPO must be organized and operated for any purpose other than to make a profit
- Under the ITA, registered charities can lose their charitable registration if they carry on a business that is an “unrelated business”, i.e. a business that is not a “related business” as defined under the ITA



- With the exception of private foundations, charities can carry on “related business” activities but NPOs can’t
- It is first necessary to understand what constitutes a “business activity”
- 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
- This definition would have similar application for NPOs for purposes of this presentation



- 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, and/or
  - Whether the person or organization undertaking the activity has been selected because of commercial knowledge, skill, or experience



- Examples by CRA of income-generating activities by a charity that are not considered a business:
  - Soliciting donations;
  - Fundraising;
  - Selling donated property, if not done continuously;
  - Charging fees in providing charitable programs, such as ticket sales and rent from low-income housing programs; and
  - Community economic development programs (described below)



13

- Indicators identified by CRA that income generating activity by a charity is not a business:
  - The fee structure is to defray 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



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14

## D. BUSINESS INCOME FOR NPOS

- To qualify as an NPO, an organization must meet all 4 requirements under par. 149(1)(l) of the ITA throughout any taxation year
  1. Not be a charity
  2. Be organized exclusively for social welfare, civic improvement, pleasure, recreation or any other purpose except profit
  3. Be operated exclusively for social welfare, civic improvement, pleasure, recreation or any other purpose except profit
  4. Not distribute or otherwise make available for the personal benefit of a member any of its income



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15



- Tax exempt status under par. 149 (1) (l) is a question of fact that can only be determined after a review of the purposes and activities of the NPO
- It is possible for an organization to qualify for exemption as an NPO for a period shorter than its fiscal year
- Being incorporated as a not-for-profit under corporate legislation does not necessarily mean that the organization is an NPO for tax purposes
- See *CRA IT-496R, Non-Profit Organizations* for more details

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16

## NPO Requirement #2: Must be *Organized for Non-Profit Purposes*

- NPOs must be organized exclusively for social welfare, civic improvement, pleasure, recreation or any other purpose except profit
- When determining the purpose for which an NPO was organized, the documents creating the NPO will normally be reviewed, including letters patent, articles of incorporation, memoranda of agreement, by-laws, etc.
- This requirement is rarely an issue, although some CRA audits have commented on problematic dissolution provisions in this context

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## NPO Requirement #3: Must be *Operated* for Non-Profit Purposes

- NPOs must in fact be operated exclusively for social welfare, civic improvement, pleasure, recreation or any other purpose except profit
- This is the criteria that is the subject of the most uncertainty for NPOs
- CRA is generally of the view that an NPO can engage in commercial activities and earn a profit, provided that it is an unanticipated and unintentional profit
- However, if it would be unable to undertake its not-for-profit activities but for undertaking profitable activities, the organization may not be an NPO because it would have an underlying profit purpose

- Can have reasonable operating reserves
- Can engage in limited fundraising activities
- CRA rules on profit generation by NPOs is currently in a state of flux as a result of confusing CRA rulings and interpretations since 2009 compared to earlier case law
- As such, the use of NPOs to carry on business activities designed to generate self-sustaining revenue as a form of social enterprise is not currently a realistic option
- However, there may be opportunities to generate business income through either a for-profit subsidiary or even a charity as explained below



## E. RELATED BUSINESS INCOME FOR CHARITIES

- The ITA permits charitable organizations and public foundations to carry on “related businesses” as described below
- However, private foundations cannot carry on any business activities (“related” or otherwise)
- 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 in the process



- Non-compliance resulting from engaging in businesses that are not a “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; and/ or
  - 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

## 1. 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 (like PEI church lobster dinners)



## 2. Linked and Subordinate to Charitable Purposes

- (a) 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



23

- 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; and
  - Earns 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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24

- 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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(b) 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; or
- The charity continues to operate for an exclusively charitable purpose by permitting no element of undue private benefit to enter into its operations



## F. OTHER SOURCES OF INCOME GENERATION FOR CHARITIES



- The following are examples of other sources of income generation by a charity as 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 the program related investments and loans would not
- See CRA Guidance (CG-014) on Community Economic Development Activities (CED Guidance) for full details

## 1. 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

- 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 and supervisors
- Work must match the special needs of the disabled and to relieve conditions associated with the respective disabilities
- CRA does not prohibit a social business from earning a profit, so long as the focus is on helping eligible beneficiaries

## (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)

Help  
Wanted

- 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.; and
  - 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





## (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
  - be a “related business” under the ITA

## (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



33

## (e) Micro-Finance and Loan Guarantees

- The CED Guidance (CG-014) expands the ability of charities to provide loans to achieve a charitable purpose, including micro-finance 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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34

- 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 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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## 2. 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, although permitted PRIs are not required to generate a return of capital for the charity or yield interest
- Charities are also now permitted to conduct PRIs with non-qualified donees

### (b) Types of PRIs

- Loans and loan guarantees - to another organization to allow the other organization to pursue 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



37

- 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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38

## (c) Requirements for 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; and
  - Evidence of direction and control over PRIs to non-qualified donees



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## G. UTILIZING A FOR-PROFIT SUBSIDIARY TO GENERATE INCOME

### 1. Business Income for NPOs through a For-Profit Subsidiary

#### (a) Generally

- In order for an NPO to avoid carrying on a for-profit business activities that could jeopardize its tax exempt status, an NPO may want to consider a for-profit subsidiary
- CRA has indicated that an NPO can derive income from a taxable subsidiary owned by an NPO
- However, the availability of this option depends on the facts of each case

- For instance, an NPO using “excess funds” to purchase and make loans to a taxable subsidiary may be viewed as having a profit motive, since CRA may see that the NPO has raised more funds than needed to do its non-profit work
- The NPO may therefore need to look at alternative funding for the for-profit subsidiary, such as possibly the sale of an operating division of the NPO for FMV, with re payment over time with interest

## (b) Tax Liability

- Tax would have to be paid on the income earned by of the subsidiary corporation
- As well, it is not possible to make a tax deductible donation to the NPO parent as can be done with a donation by a for-profit subsidiary of a charity
- However, some management service fees and sponsorship fees may be charged by the NPO to the for-profit subsidiary to reduce income of the for-profit subsidiary



## 2. Unrelated Business Income for Charities Through a For-Profit Subsidiary

### (a) Generally

- 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 a subsidiary to operate the “unrelated business”
- A subsidiary corporation could also be effective in containing liability within the corporation
- However, in doing so, there are a number of factors that would need to be carefully considered, including the following:

## (b) Tax Liability Under ITA

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



## (c) Charity Owning an Interest in a Business

- Having a charity acquire a 100% interest in a for-profit corporation was previously prohibited by the *Charitable Gifts Act* before it was repealed in 2009
- The issue to look at now is whether owning and investing in a for-profit corporation constitutes a prudent investment under the *Trustee Act*



- (d) 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%

### 3. Governance and Cross-Over Liability Issues with For-Profit Subsidiaries

- Corporate governance and the potential for cross-over liability are issues when utilizing for-profit subsidiaries
- The for-profit subsidiary will need to have a separate board of directors elected by the parent (e.g. the charity or NPO)
- The more overt control by the parent over day to day operations of the for-profit subsidiary, the greater the chance of cross-over liability between the subsidiary and the parent



## H. CONCLUSION



- NPOs and charities can have an important part to play within the spectrum of social enterprise
- The key factor to remember is that charities are heavily regulated and NPOs have significant limitations in making a profit
- It is therefore necessary to understand what NPOs and charities can and cannot do with regards to generating income before pursuing the option of “going into business”

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