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**CONSIDERING GOING
INTO BUSINESS?
THE SOCIAL ENTERPRISE
SPECTRUM FOR
CHARITIES AND NPOs**

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 <p>BARRISTERS SOLICITORS TRADEMARK AGENTS</p>	<h2>CPA Canada Not-for-Profit Forum 2021 February 9, 2021</h2>
<h3>Considering Going into Business? The Social Enterprise Spectrum for Charities and NPOs</h3> <p>(Current as of January 14, 2021)</p> <p>By Terrance S. Carter, B.A. LL.B., TEP, Trade-mark Agent tcarter@carters.ca 1-877-942-0001</p> <p>© 2021 Carters Professional Corporation</p>	
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	2
<h3>OVERVIEW OF TOPICS</h3> <ul style="list-style-type: none">• Why “Going into Business” Matters for Charities and NPOs• The Social Enterprise Spectrum• What Does “Business” Mean?• Revenue Generating Charitable Programs• Program Related Investments• Related Business Income for Charities• Business Income for NPOs• Utilizing a For-Profit Subsidiary• Conclusion	
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A. WHY “GOING INTO BUSINESS” MATTERS FOR CHARITIES AND NPOs

- Many charities and NPOs consider going into business to supplement their income, particularly due to COVID-19
- “NPO” refers to a “non-profit organization” under par. 149 (1)(l) of the *Income Tax Act* (ITA), also known as “not-for-profits”
- Charities and NPOs will often (but not necessarily) want their business activities to help achieve their purposes, whether those purposes are charitable or non-profit

- In doing so, many charities and NPOs may think in terms of wanting to undertake a “social enterprise”
- However, there is much confusion about what “social enterprise” means and what types of business activities charities and NPOs can engage in
- The “devil is in the details” very much applies to this topic
- This presentation explores what some of those details are
- However, important to obtain legal advice

B. THE “SOCIAL ENTERPRISE” SPECTRUM

- In its most basic form, a “social enterprise” can be described as a revenue-generating business dedicated to achieving a social purpose
- A social enterprise is not generally expected to provide a significant return for its investors, since the focus is on achieving a social purpose rather than simply making a profit
- A social enterprise can be undertaken by for-profit corporations, charities, as well as by NPOs to a limited extent

- The ongoing public interest in social enterprise in Canada has been reflected in the introduction of provincial social enterprise legislation
 - B.C. Community Contribution Companies (C3s) July 29, 2013
 - Nova Scotia Community Interest Companies (CICs) August 2, 2016
 - B.C. Benefit Companies June 30, 2020
- It is also possible for a for-profit corporation to seek certification as a Certified B Corporation (U.S. designation)

7

- Any for-profit corporation in Canada (either federally or provincially) can be structured to achieve a social purpose in making a profit through appropriate share attributes and/or unanimous shareholder agreements
- This is because, unlike in the U.S., for-profit corporations in Canada have a broader mandate at law than simply “shareholder primacy” (SCC in *BCE Inc. v 1976 Debentureholders*)
- However, for-profit corporations as social enterprises are taxable entities with no tax incentives for investors
- NPOs, though, are generally exempt from tax

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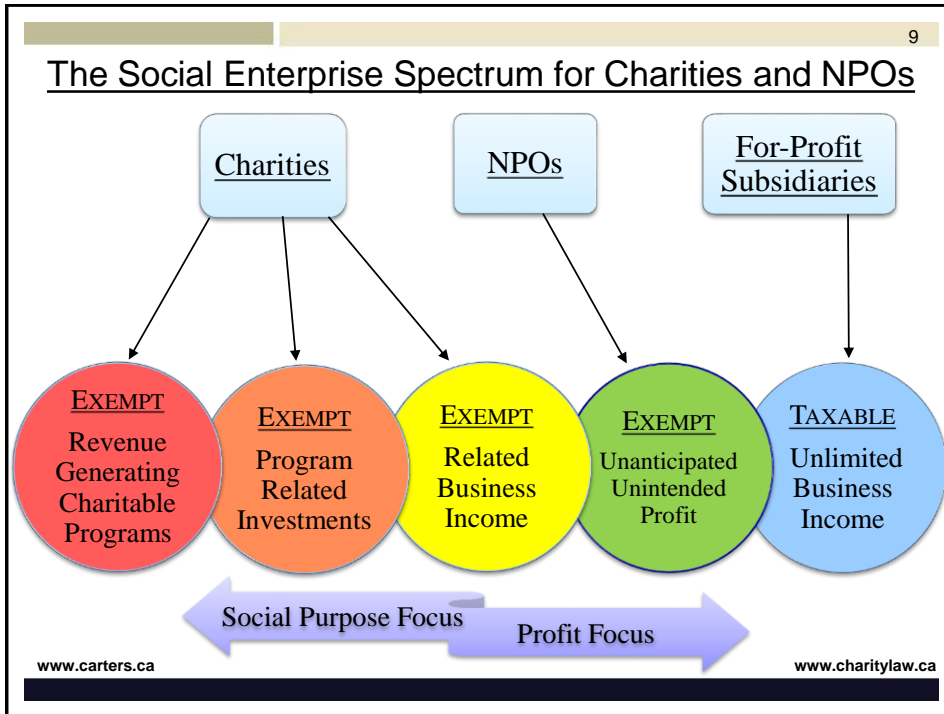
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8

- Charities are exempt from tax, can issue charitable receipts for donations, and can receive gifts from other registered charities
- The challenge for charities and NPOs is to fulfill their respective purposes when operating a social enterprise and still be compliant with their tax exempt/charitable status
- To do so, it is important to understand:
 - what “business” means
 - what are the business and other revenue-generating activities charities and NPOs can engage in

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10

C. WHAT DOES “BUSINESS” MEAN?

- Neither charities nor NPOs can have the purpose of a for-profit business
- Under the ITA, registered charities can lose their charitable registration if they have a business purpose or carry on a business that is an unrelated business, *i.e.* a business that is not a “related business” (described below)

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- 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”
- 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”

- 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

13

- Examples by CRA of revenue-generating activities by a charity that are not considered a “business”:
 - Soliciting donations because it does not involve a commercial activity
 - Selling donated goods if not done continuously
 - Charging fees in providing charitable programs, such as ticket sales and rent from low-income housing programs
 - Community economic development programs (described below)

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14

- “Carrying on” a business implies that the commercial activity involves continuous or regular operation
- Certain business-like activities will not be considered to be “carrying on” a business when they are not operating regularly or continuously, e.g.:
 - sponsorship when done irregularly
 - fundraising campaigns, including cause-related marketing
- Passive investments arising from mere ownership of assets is not a business

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D. REVENUE GENERATING CHARITABLE PROGRAMS

1. Charging Fees for Charitable Programs and Related Goods

- CRA Guidances on Fundraising (CG-013) and Public Benefit (CPS-024)
- Charging fees for charitable programs and related goods will be seen as charitable if:
 - Serves the charity's beneficiaries;
 - Directly furthers a charitable purpose; and
 - Typically aimed at cost recovery

- Examples include:
 - *University and college tuition fees*
 - *Hospital health care services*
 - *Symphony ticket sales*
 - *Museum ticket sales*
 - *Counselling fees*
 - *Rent from low income housing*
 - *Fees from long-term care facilities*
 - *Sale of religious literature*
- If profits result, charities are able to maintain these profits as a reserve

2. Social Businesses for Individuals with Disabilities

- CRA explains in its CED Guidance (CG-014) 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 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

3. Employment-Related Training for the Unemployed

- The CRA CED Guidance (CG-014) 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)

- 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 time limited on-the-job training in vocational or work skills that enhance employability, but not permanent jobs
- CRA permits charities to generate incidental profits from these programs

4. Low Income Rental 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” as discussed below

5. Loans and Loan Guarantees

- The CRA CED Guidance (CG-014) allows charities to provide loans to eligible beneficiaries 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. loans help eligible beneficiaries attend courses to enhance their employability or establish a business

- 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 delay repayment, or
 - Higher rates of interest if high loan-loss experience

E. PROGRAM-RELATED INVESTMENTS

1. What are PRIs?

- PRIs are investments that directly further the charitable purposes of the investing charity
- PRIs are not investments in the conventional sense because, while PRIs may generate revenue and a return of capital, they are not made for that reason
- Not available for advancement of religion

2. 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
 - Interest rates are expected to be at below fair market value
- Leasing land and buildings – buying a building and leasing it to an organization to accomplish a charitable purpose, e.g. for educational purposes of running a school

- Share purchases – purchase shares in a for-profit company to accomplish its charitable purpose, e.g. operating an apartment complex for the poor
 - However, public and private foundations cannot acquire a controlling interest in a company (unless by gift)
 - Private foundations are also subject to other restrictions, such as divestment obligations for shareholdings above 20%, under excess corporate holding rules

3. 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;
 - Evidence of direction and control over PRIs to non-qualified donees
 - Exit mechanisms to withdraw from a PRI or convert it to a regular investment if it no longer meets the charity's charitable purpose;

- Must ensure that any private benefit is incidental (*e.g.* necessary, reasonable and proportional);
- Must meet all applicable trust, corporate and other legal and regulatory requirements; and
- Must maintain adequate books and records to prove compliance
- PRIs & loans do not count toward 3.5% DQ
- For charities in Ontario, may also need to comply with Social Investment requirements under the *Charities Accounting Act (CAA)*

F. RELATED BUSINESS INCOME FOR CHARITIES

- CRA 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

- Non-compliance, though, 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” 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 done on an annual basis
 - e.g. calculation is based on the number of people used to operate the business rather than 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:
 - i. 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

33

- ii. 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
- iii. A use of excess capacity;
 - 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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34

- iv. 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; and
 - The charity continues to operate for an exclusively charitable purpose by permitting no element of undue private benefit to enter into its operations

G. 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 each taxation year

1. Not be a charity (registered or common law)

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 any income for the personal benefit of a member

37

- 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
- Being incorporated as a not-for-profit corporation under corporate legislation does not necessarily mean that the organization is an NPO for tax purposes under the *ITA*
- See *CRA IT-496R, Non-Profit Organizations* for historical position on NPOs
- More recent rulings from CRA have created uncertainty (discussed below)

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38

NPO Requirement #1: Must be *Organized* for a Non-Profit Purpose

- 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, by-laws, etc.

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NPO Requirement #2: 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 of 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
- As such, the use of NPOs to carry on business activities designed to generate revenue as a form of social enterprise would involve risks
- May be opportunities, though, to generate business income for a NPO through a for-profit subsidiary (explained below)

H. UTILIZING A FOR-PROFIT SUBSIDIARY

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

a) Generally

- In order to avoid a charity carrying on an “unrelated business” with resulting penalties and/or revocation, a charity might consider incorporating a for-profit corporation to act as a subsidiary to operate an “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:

i. 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 from placing “unrelated business” activity in a for-profit subsidiary could be quite low, depending on the circumstances

ii. Charity Owning an Interest in a Business

- The charity would need to justify the investment of charitable resources as either:
 - A prudent investor standard under applicable provincial *Trustee Acts*
 - A PRI under the CRA's CED Guidance (and possibly as a "Social Investment" in Ontario under the CAA)
- In Ontario, PGT has the right under the CAA to inquire into "substantial interest" in a business (20%)

iii. 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%

2. 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 shares and/or 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
 - e.g. possibly the sale of an operating division of the NPO to the for-profit subsidiary at FMV, with re-payment over time with interest

b) Tax Liability

- Tax would have to be paid on the income earned by the subsidiary corporation
- However, unlike a charity, it is not possible to make a tax deductible donation to the NPO parent
- Some management service fees and sponsorship fees, though, may be charged by the NPO to the for-profit subsidiary to reduce income of the for-profit subsidiary

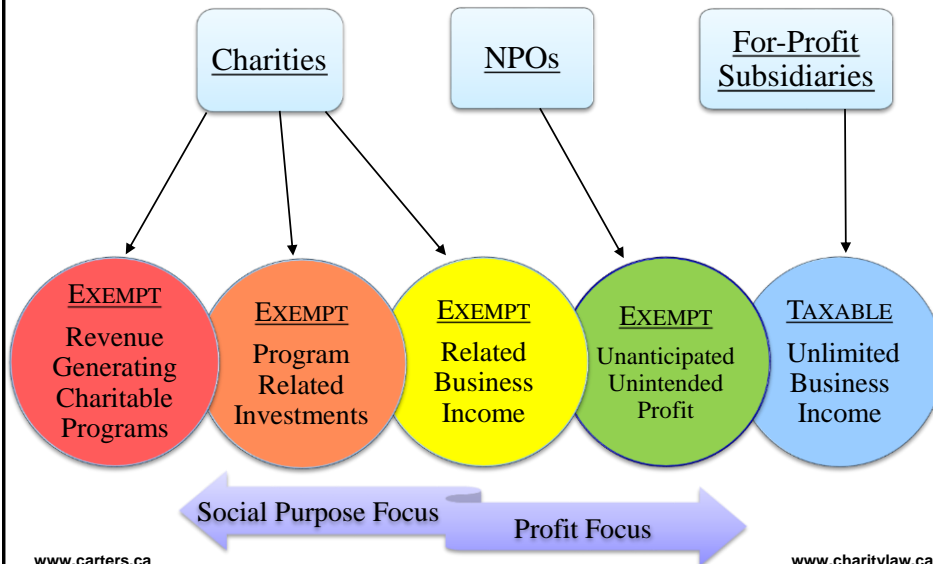
3. Governance and Cross-Over Liability Issues with For-Profit Subsidiaries

- Corporate governance and the potential for cross-over liability are issues to consider 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

I. CONCLUSION

- Charities in particular, as well as NPOs, can have an important part to play within the developing social enterprise landscape in Canada
- However, confusion in terminology and options can easily occur
- It is therefore important to have a clear understanding of what charities and NPOs can and cannot do with regards to social enterprise when pursuing the option of “going into business”
- Remember the “Social Enterprise Spectrum”:

The Social Enterprise Spectrum for Charities and NPOs



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