Social Enterprise in Canada[1]

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Over the past decade or so in Canada, as in the United States, there has been an explosion of interest in the concept of "social enterprise". What does it mean? How does it work? How does it fit within our traditional structures? As financial pressures have driven charities and non-profits to seek new sources of revenue to support their activities, and as individuals and organizations have sought the ability to combine both private and philanthropic goals, many have turned to "social enterprise" as a possible answer to both these questions.

Finding a consistent definition or definitive meaning of "social enterprise" can sometimes be challenging. Hold a meeting of 30 or 40 different professionals who work in the public benefit sector, and you will likely find there are at least 20 different perspectives on what exactly is meant by the pursuit of a social enterprise.

Broadly speaking, for the purposes of this article, we suggest that the term references the pursuit of primarily (though perhaps not exclusively) social goals through an entrepreneurial structure and lens. Proponents of social enterprise work to develop sustainable and profitable models to support socially beneficial activity that is critical to our communities. The interest in developing such models has increased in particular because the traditional sources of funding for social needs – public donations and government grants – are either decreasing or have dried up.

Certain forms of social enterprise are already familiar in the US (as in other jurisdictions). Non-profit organizations in the US, for example, are permitted to make a broad range of "program-related investments" (PRIs) in a wide range of entities. These are investments – loans or share purchases, not grants or one-time expenditures – made with the purpose of furthering a social mission rather than generating return on investment. By contrast, Canadian registered charities are highly limited in their ability to make PRIs. Certain US states have also developed special corporate legislation to accommodate the use of for-profit activities in pursuit of a social purpose, as well as to facilitate public investment in the enterprise without relying on the traditional tax incentives for public donations — government grants and private donations. In Canada, no such legislation has yet been passed and Canadian law remains largely divided between traditional non-profit and for-profit models.

Notwithstanding that Canadian law is in some ways still catching up to the range of social enterprise models that have emerged, it is possible to carry on a range of social enterprise activities within the available Canadian for-profit and non-profit forms. It is, however, crucial that organizations and advisors fully understand the structural options available, as well as the benefits and limitations of each in the context of social enterprise.

This article will survey at a high level how organizations can work within the existing Canadian tax system to pursue socially beneficial or charitable goals through for-profit or business-like activities. We will review the structural models by which organizations can pursue social goals, and the advantages and limits of these options where social enterprise is concerned. We will then review structural innovations in other jurisdictions designed to facilitate social enterprise, and how Canada may slowly be moving in this direction.

Structural Options for Social Enterprise in Canada

a) Operate as a Registered Charity

The *Income Tax Act* (Canada)(the "*ITA*") provides that organizations meeting certain criteria can be registered with the Canada Revenue Agency ("CRA") as charities. Very briefly, charities must be organized for exclusively charitable purposes and must devote all resources to charitable activities, subject to certain limited allowances for fundraising and administrative expenses. Registration confers two primary benefits. First, registered charities benefit from a general exemption from tax under the *ITA*. Second, registration confers the ability to issue charitable donation tax receipts for charitable donations received, which in turn enables public donors to claim tax credits or deductions for charitable gifts.

Canadian registered charities have been pursuing revenue generating activities in support of their charitable purposes for years. Charities do this in two ways. First, they may generate revenues by charging fees for the charitable services they provide. A classic example would be a university charging tuition for education programs it offers. Other examples are hospitals charging fees for health care services or community organizations charging for their programming. These activities are revenue generating and in some cases may be entrepreneurial. Each of these is an example of the delivery of charitable activity for consideration. This is permitted under the provisions of the *ITA*.

The other way that registered charities pursue social enterprise type activities is by relying on the provisions of the *ITA* that permit charitable organizations and public foundations to carry on 'related business' activities. To distinguish this activity from the type of revenue generating activity we referred to above, consider a hospital charging for parking – this is a revenue generating activity that is related to the charitable operations but not a direct charitable activity being delivered. Another example would be a community center renting excess space to third parties when the space is not needed for the objects of the community center. These activities would generally be acceptable as a related business.

In Canada, unlike the United States, a charity is not permitted to pursue an unrelated business activity. In fact, carrying on an unrelated business is grounds for revocation of charitable registration. There is no unrelated business income tax in Canada — there are penalties for such activity in addition to the risk of loss of charitable status. This highlights the concerns many have about using registered charities to pursue social enterprise. If the revenue generating activity is not a charitable activity then it must be a related business or cannot be conducted.

It is critical therefore when considering whether a charity can pursue a social enterprise to understand what constitutes a related business. The *ITA* provides that a related business includes a business that is unrelated to the objects of the charity if it is carried on substantially by volunteers. Where the activity is not carried on substantially by volunteers, the charity must demonstrate that the business activity is related to the objects of the charity.

Early case law on the definition of related business took a permissive approach, essentially adopting a "destination of funds" test for related business: provided that the business or commercial activity of a charity generated funds which were used in exclusively in charitable activities, the business activity was *ipso facto* related. However, later case law rejected the destination of funds test, and the CRA policy which has emerged provides that business activities (if not run substantially by volunteers) will only be found to be related when they are "linked and subordinate" to the charity's charitable purposes. Examples of what constitutes "linked and subordinate" include a business activity that is an offshoot of a charitable program, a typical concomitant of a charitable program, a use of excess capacity, or a means of promoting the charity or its purposes. The business activity must also play a clearly minor role, in terms of both resources and attention, in comparison to the charity's charitable purposes.

The concern raised by some in the sector is that the registered charity is often not an ideal vehicle for directly carrying on most business activities with a view to generating profits for use in charitable activities because of these rules. This picture would change with adoption by the courts of a "destination of funds" test for related business – a change which would be welcomed by the voluntary sector – but barring such a development, charities are still able to make limited use of business activities as a source of revenue. Some argue this limits charities as an optimal structure for carrying on social enterprise, which frequently involves business-like elements. Others however have worked within this system for years and in fact the existing system does provide charities much flexibility to pursue social enterprise.

Another of the drawbacks identified in connection with the pursuit of social entrepreneurial activities through registered charities is that there is only limited scope for motivating private investment in a charity. Charities are typically established as trusts or non-share capital entities. Thus there is the opportunity to lend to charities but otherwise not much scope for investment.

Many observers have identified the fact that there are venture capitalists and others in the economy who would be prepared to advance funds on an investment basis to support social benefit activity notwithstanding that such investment may generate a slightly lower return than would be available from investment in pure for-profit entities. The individuals and organizations interested in such investments would place value on the non-quantifiable social benefit generated by the charity. However,

under the current rules, such equity investment in a registered charity is generally not possible.

b) The Business Corporation

Perhaps the most flexible potential vehicle for the carrying on of social enterprise in Canada is the business corporation. There are two primary advantages to the use of a business corporation incorporated under the *Canada Business Corporations Act* ("*CBCA*") or its provincial equivalents. The first is the relative absence of regulation on the purposes and activities of the corporation. Generally speaking, business corporations are free to conduct any business activities they wish, in collaboration with whomever they wish, and may use the proceeds of these activities as they wish (subject to provisions of their articles and bylaws). Another advantage of the business corporation is the relative flexibility of its capital structure, which can allow for the attraction of private investment (with no formal cap on returns). Share conditions can be drafted to limit the potential return on investment so as to ensure that a set percentage of earnings will be available for the social purposes of the corporation, which percentage could be adjusted to adapt to differing economic circumstances. If desired, the corporation could adopt formal restrictions on shareholder returns.

One downside of running the social purpose activity through a for-profit entity is that it is not possible in most instances for a charitable foundation to direct any of its endowment assets into an investment in the activity (because the corporation is not a "qualified donee" under the *ITA*). This limits the ability of the corporation to attract funding from the charitable sector.

Another disadvantage to the business corporation is that it does not benefit from the tax benefits available to charities and non-profit organizations. Business corporations are taxed on their income and cannot issue donation receipts to donors. This, however, may not be as significant a hurdle as it might at first seem, because currently under the *ITA* corporations can deduct up to 75 per cent of their annual income on account of charitable donations and have available to them a variety of ways of structuring social activities so as to minimize the taxes payable. The result is that a socially-oriented business corporation could find itself with not a great deal more tax payable than a fully tax-exempt charity or non-profit organization.

The final disadvantage relates to public perceptions of business corporations. Where commercial social activities are operated through a for-profit corporate entity, there is a risk that the owners of the entity may be perceived to be using the mantra of a "social purpose" to create wealth and profit for their own good. This concern is understandable, and to the extent that for-profit entities give rise to this perception, entrepreneurs having a social perspective often prefer to use alternative structures to further their social goals.

c) The Non-Profit Organization

Social enterprises in Canada are often structured through a non-share capital organization. The benefit to the use of such an entity is that it might qualify for tax exempt status under the *ITA* definition of "non-profit organization". The definition of a non-profit organization under the *ITA* clearly contemplates that the entity will have a social benefit purpose (which, it should be noted, is distinct from a charitable purpose). Such entities are generally (although not always) established as non-share capital entities so that there is not a concern about owners and shareholders accumulating wealth. As such, these entities can earn revenues on a tax exempt basis but it is not possible for third parties (either individuals, for-profit entities or charities) to subscribe for share capital or invest in the way that it would be possible with a share capital corporation.

Notwithstanding these limitations, there are many examples of social enterprises in Canada which have been successfully operated using this structure. However, in the past year or so, CRA has raised concerns that non-share capital organizations which purport to qualify as non-profit organizations under the *ITA* by pursuing commercial activities for social purposes may not be eligible for the tax exemption because they are in fact generating profits.

This concern is being raised by CRA on the basis that one of the elements in the definition of a non-profit organization is that such an entity must be established for purposes other than to make a profit. When such entities operate revenue generating activities for a social purpose, they generally want to generate a profit (although this profit is then directed to the social purpose identified). Unfortunately, CRA has taken the view that if the entity intends to make a profit – even if the profit is directed to a social benefit purpose, that the entity does not qualify for the tax exemption. This attacks the very essence of a social enterprise in that generally it is thought that the enterprise will generate profits to further its social purpose. CRA has acknowledged this is a fact-based determination, but its recent comments have created a something of a chill in the sector.

Whether this means that the non-profit organization is no longer attractive to communities which intend to pursue social enterprise is a question that will have to be determined, but it is definitely a concern to those realising the benefits of the non-profit organization.

Developments in Other Jurisdictions

Legislative developments in the United Kingdom, as well as several US states, have responded to the development and growth

of social enterprise with the creation of special hybrid entities designed to facilitate social enterprise. The United Kingdom has created the Community Interest Company ("CIC") and several US states have legislated for the low-profit limited liability company ("L3C"). Although there are several differences in the structure of these entities, both are designed to enable the furtherance of charitable and social goals through for-profit activities, as well as a more flexible capital structure than is available with traditional non-profit corporate forms.

a) United Kingdom

In the United Kingdom, legislation was passed to permit the creation of what is referred to as "community interest companies" ("CIC"). The CIC structure is designed to permit the use of for-profit and entrepreneurial activities in the pursuit of community benefit purposes. It is also intended to provide for investment by third parties and for-profit entities in a way that is not generally possible in traditional charitable and non-profit structures.

The basic legal structure for CICs is the limited liability company, which can be structured as a private company limited by guarantee or by shares, or a public company. Unlike registered charities, CICs are not required to restrict their objects to particular activities but are required to meet a "community interest test" which evaluates the underlying purpose of a company's activities. In order to satisfy the test a company must show that a reasonable person would consider that the purpose towards which its activities are ultimately directed is the provision of benefits for the community, or a section of the community. This restricts a CIC from carrying on activities that benefit *only* its members and/or employees, but imposes few other limits.

The assets of CICs are subject to an "asset lock". A CIC's assets must either be retained within the CIC to be used for the community purposes for which it was formed, or, if they are transferred out of the CIC, must be transferred for full market value consideration or to another asset-locked entity (*e.g.*, another CIC or registered charity).

CICs are permitted to pay dividends to shareholders, but such dividends are subject to a cap which is designed to strike a balance between encouraging people to invest in CICs and the principle that the assets and profits of a CIC should be devoted to the benefit of the community. This helps to ensure that the dividends are not disproportionate to the amount invested and the profits made by the company.

There are three central advantages to using a CIC rather than a charity as a means of engaging in social enterprise. First, the purposes and activities which a CIC may undertake are considerably broader and more flexible than a traditional charity, being required to meet only a general community interest test; this allows CICs to engage in business-like activities in support of their social purposes. Second, CICs are permitted to provide limited return on private investment, enabling them to raise capital without relying on outright donations. Finally, the asset lock and community interest test provide public assurance that the funds of a CIC will be used for socially beneficial purposes. The central disadvantage is that, unlike charities, CICs are not tax-exempt and investments or donations to them do not receive favorable tax treatment.

b) United States

As noted, in the United States, social enterprise has been promoted through the use of low profit limited liability companies. The first limited liability company statute was passed in Vermont in 2008. At the time, it was thought that the L3C structure would encourage entrepreneurial-type activities alongside social benefit work and ultimately the creation of profitable public benefit activities.

Since the enactment of the Vermont statute, at least five other States in the United States have passed similar legislation. However, at the time of writing, complementary sections have not been added to the Internal Revenue Code. Thus, like the CICs, an L3C has no special tax exempt status. Another drawback from the US approach is that the L3C does not have any special status that would permit it to attract investment from private foundations in the US.

The structure of the L3C is similar to the CIC structure referred to above. L3Cs do not need to be organized for exclusively social purposes, but must be organized to significantly further the accomplishment of one or more charitable or educational purposes, and must be able to say that it would have been formed but for its relationship to the accomplishment of such purpose(s). L3Cs can also be structured to permit private investment in ways which could not be achieved with a traditional 501(c)(3) organization. L3Cs are permitted to have varying tranches of investors, with some tranches receiving below-market returns (designed for program-related investments by US foundations) and others receiving market rates of returns.

In order to make L3Cs attractive in the way the proponents of social enterprise intend, it will likely be necessary to amend the Internal Revenue Code to provide for a special tax status for the L3C, and in particular, to suggest that the L3C is eligible for program related investments by private foundations in the United States. Without these changes, it is uncertain whether the changes proposed will have the impact on social enterprise that was originally intended.

c) Canada

Canada has not to date seen the introduction of legislation which would provide for a new form of corporate structure similar to the CIC in the United Kingdom or the L3C in the United States. There are signs, however, that some jurisdictions in Canada may follow the UK or US examples and introduce their own versions of hybrid entities designed to accommodate social enterprise. Most notably, in 2010, the British Columbia Ministry of Finance issued a consultation paper requesting public input on the development of a CIC-regime in British Columbia, modelled after the UK regime. Other groups across Canada have made submissions to all levels of government seeking the development of hybrid corporate forms. Though their efforts outside of BC have not thus far been successful, it is possible, particularly if hybrid forms become popular vehicle for social enterprise in the UK and the US, that many jurisdictions in Canada will follow suit.

In Canada, if legislation is enacted to permit a special status corporation for the pursuit of social enterprise, there would also be the additional hurdle of amending the *Income Tax Act* to treat this new entity as tax exempt and/or to permit this new form of corporate entity to be considered a "qualified done". This latter change is required to access investment from charitable foundations registered in Canada. The pursuit of such changes and such amendments is ongoing and will continue at many levels of government.

Conclusion

This article has only briefly touched upon the legal issues and structural options related to social enterprise. However, even a brief review reveals both the limits and possibilities in the current legal landscape. This landscape is limited in the sense that it does not provide for a single, well-defined structure to facilitate social enterprise. However, despite the fact that Canadian law has not developed specialized corporate forms for social enterprise, it is possible to work within the existing tax and corporate structures available in Canada to conduct a wide range of activities that fall under the rubric of social enterprise. Indeed, on examination of the structural options available in Canada, it becomes evident that there are relatively few structural approaches available under specialized social enterprise legislation that cannot be accomplished using existing corporate forms with some customization of the purposes, governance and capital structure. While further discussion and debate on appropriate legislative innovations to facilitate social enterprise are welcomed, organizations seeking to engage in such activities should take heart that with careful consideration of the legal issues involved, they can find a structure within the existing landscape that will suit their goals. ■

1. This article is based on an earlier article published for the Horizons Policy Research Initiative: Susan Manwaring & Andrew Valentine 'The State of Social Enterprise in Canada', paper published by Policy Institute Canada (February, 2011) available at <http://www.horizons.gc.ca/page.asp?pagenm=2011_0061_Manwaring>.
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