
CANADIAN STRUCTURAL OPTIONS FOR SOCIAL ENTERPRISE

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SOCIAL ENTERPRISE IS A BROAD CONCEPT.¹ LITERATURE ON THE SUBJECT TENDS to emphasize its hybrid nature, combining aspects of both traditional for-profit and non-profit operational models and comprising a spectrum of activities which may fall closer to one end of the spectrum or the other.² In its broadest sense, social enterprise denotes the pursuit of primarily (though not necessarily exclusively) social goals through for-profit or market-oriented activities. Social enterprises attempt to develop sustainable funding models for socially beneficial activity that do not rely on the traditional sources of funding for the voluntary sector – government grants and public donations.

In this article, we 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, without reliance on traditional sources of voluntary sector support. We review the traditional structural models by which charities have pursued social goals and the advantages and limits of this approach where social enterprise is concerned. Finally, we consider how Canadian organizations can work within the existing system to accomplish similar goals.

Canada has not adopted a hybrid corporate form to facilitate social enterprise, although recommendations for such innovation have been made in Ontario.³ Such hybrid corporate forms have been adopted in the United Kingdom and the United States with some success. In the absence of such innovations, what structures other than a registered charity can be used in Canada to carry on social enterprise?

We first review the answer in the context of an operating charity. We then review two choices often considered as more satisfactory responses to this question: the business corporation and the nonprofit organization.

OPERATING AS A REGISTERED CHARITY

(a) General

The Income Tax Act (Canada)(the ITA) provides that organizations meeting certain criteria can be registered with the Canada Revenue Agency (CRA) as charities.⁴ 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.⁵ Second, registra-

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tion 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.⁶

Because charities and their donors benefit from a significant tax expenditure, they are subject to fairly restrictive rules concerning the use of their funds.⁷ For the most part, charities are permitted only to expend funds on the relatively narrow category of activities which qualify as charitable at law, or on gifts to other qualified donees (for the most part, other registered charities). Although charities may pay reasonable compensation to employees,⁸ they are not permitted to confer private benefits on any individual or organization. Charities are also subject to rules on how they fundraise in support of their charitable mission. In particular, charities are limited in the forms of business-like activities that they may undertake to generate revenue for use in charitable activities. These restrictions are premised on an operational model that assumes reliance by charities to a large degree on government grants and public donations. Provided that such sources of support are maintained, charities will have sufficient funds to carry out their core activities. However, in difficult economic climates, when shrinking returns on endowment funds limit grants from community foundations, and when private donations are frequently reduced, charities (and smaller charities in particular) must consider other available means of generating revenue than outright grants and donations.

(b) Generating revenue through business activities

Charities seeking to engage in business-like activities are subject to a complex array of rules. The ITA provides that charitable organizations and public foundations (but not private foundations) may carry on “related business” activities.⁹ For charitable organizations, expenditures on such activities are deemed to be expenditures on charitable activities.¹⁰ Because there is no limit on charitable expenditures, the deeming rule allows a charitable organization to carry on unlimited related business activities.

However, the interpretation of “related business” that has emerged in the courts has resulted in a relatively restrictive set of rules to which charities must adhere when carrying on any business activities, in order to ensure that CRA will regard them as related. 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. Otherwise, the ITA leaves it to the courts and CRA policy to set the parameters of related versus unrelated business. Maintaining compliance is important, as carrying on an unrelated business is grounds for revocation of charitable registration.

Early case law on the definition of related business took a permissive approach,¹¹ 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,¹² 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.¹³ This requires that the business activity be either 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.

CRA will also permit charities to carry on business-like activities when they directly further a charitable purpose.¹⁴ However, although such activities – which include, for example, forms of micro-lending and “social businesses” designed to employ hard-to-employ people – are usually structured with an intention of generating a profit, the businesses are often high-risk and cannot be sustained without support from other sources of funds. Thus, although they may provide substantial public benefits, they are not always reliable as a source of operating funds for the charity.

The picture that emerges is that the registered charity is not an ideal vehicle for directly carrying on most business activities with a view to generating profits for use in charitable activities. 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 able to make only limited use of business activities as a source of revenue. This accordingly limits charities as an optimal structure for carrying on social enterprise, which frequently involves business-like elements.

(c) Attracting investment

Charities are also limited in their ability to attract private investment. Charities in Canada cannot be organized as share capital corporations. Charitable foundations are highly restricted in their ability to issue debt.¹⁵ Charitable organizations are not as tightly restricted and should in principle be able to borrow from the public paying interest at market rates (naturally, no receipts would be issued for such investments as they would not normally constitute gifts to the charity). However, the general prohibition against the provision of private benefits casts some doubt on the extent to which a charitable organization could offer debt instruments on a wide basis to investors. The uncertainty surrounding such an approach makes it risky, with the result that few charities offer such investments.

ALTERNATIVE STRUCTURES

(a) 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, thus allowing the corporation to present itself to the public as a de facto community interest corporation.

The central disadvantage to the business corporation is that it does not benefit from the tax expenditures available to charities and nonprofit organizations. Business corporations are taxed on their income and cannot issue donation receipts to donors. Having said this, business corporations that choose to use their profits in furtherance of charitable activities can benefit from other tax expenditures and can structure their operations so as to significantly reduce the incurrence of tax. Corporations are permitted to deduct up to 75% of their annual income for donations to qualified donees, which limit can be increased with the donation of certain capital property.¹⁶ Thus, to the extent that a corporation furthers its social purposes through grants to other charities or qualified donees, this can substantially reduce the corporation's tax liability. Furthermore, various planning tools could be adopted to reduce tax for the corporation, with the result that a socially-oriented business corporation could find itself with not a great deal more tax payable than a fully tax-exempt charity or nonprofit organization.

Another disadvantage to the business corporation relates to the "brand." Most social entrepreneurs want their corporation identified with their social mission and not with the notion that they are a for-profit wealth accumulating business. As indicated above, it is possible to incorporate the social purposes of the corporation into the articles, bylaws, and share conditions of the entity. However, notwithstanding, there is a general concern that such restrictions (because ultimately they can be changed) are not sufficient to ensure the public accepts that the social purposes are the primary goal.

(b) The Nonprofit organization

Another possible option for social enterprise is the nonprofit organization.¹⁷ Like registered charities, nonprofit organizations benefit from a general tax exemption under the ITA,¹⁸ although they cannot issue tax receipts for donations. However, they are generally permitted to pursue a wider range of nonprofit purposes than registered charities and are not subject to a formal registration regime. This flexibility makes it possible to utilize the nonprofit organization structure to carry on socially beneficial activities that do not meet the legal definition of charity. For organizations that propose to rely on member fees, and non-business-like activities to accomplish social goals, this may be a viable option.

However, as vehicles to generate revenue through business-like activities, nonprofit organizations are generally not an ideal structure. In order to qualify as a tax-exempt nonprofit, an organization cannot be organized or operated for a profit purpose. Although courts have in some instances permitted nonprofit organizations to carry on certain forms of profitable commercial activity so as to support their nonprofit purposes,¹⁹ CRA policy has become increasingly restrictive in its treatment of nonprofit business activities.²⁰ CRA has suggested that if a nonprofit organization budgets for any surplus of revenues over expenses in a given year, this will be indicative of a profit purpose, which will disqualify the organization as a nonprofit organization. This means that any activities designed to generate a surplus of revenue may be challenged by CRA. Such a structure may not be ideal for the carrying on of many forms of social enterprise that rely on business-like funding models to create and sustain social benefits. Furthermore, nonprofit organizations are not permitted to make any income available to their members or shareholders. This makes it effectively impossible to use a nonprofit organization to attract private investment seeking financial return.

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. 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 and indeed encouraged, 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.

NOTES

1. For an overview, as well as specific examples of various activities that fall under the broad category of social enterprise, see the Canadian Centre for Social Entrepreneurship (URL: <http://www.business.ualberta.ca> .)
2. Terrance S. Carter & Theresa L.M. Man, "Canadian Registered Charities: Business Activities and Social Enterprise – Thinking Outside the Box" (paper presented at National Centre on Philanthropy and the Law Conference, October 24, 2008). URL: <http://www.carters.ca/pub/article/charity/2008/tsc1024.pdf> .
3. See, MaRS Discovery District White Paper Series, Social Entrepreneurship Series: Legislative Innovations (February 2010). URL: <http://www.marsdd.com/buzz/reports/sociallegal> .
4. For guidance on the registration process, see Canada Revenue Agency Guide T4063 *Registering a Charity for Income Tax Purposes*. URL: <http://www.cra-arc.gc.ca/E/pub/tg/t4063/t4063-08e.pdf> .
5. *Income Tax Act*, R.S.C. 1985, C.I.(5th Supp.) at ss. 149(1)(f).
6. Tax credits are available to individual donors (*ITA*, s. 118.1) while tax deductions are available to corporate donors (*ITA*, s 110.1).
7. We have elsewhere questioned whether the rules as administered by the Charities Directorate may in some instances exceed the jurisdiction afforded to CRA under the *ITA*: Susan Manwaring & Andrew Valentine (2010). "Comments on CRA Fundraising Guidance" *Canadian Tax Journal* 58(3),751-770.

8. The issue of what is reasonable compensation for charity employees is the current subject of legislative debate, as a result of Bill C-470, *An Act to Amend the Income Tax Act (revocation of registration)*, 3rd Sess., 40th Parl., 2010 (2nd reading in the House of Commons and referred to Committee on April 21, 2010).
9. *ITA*, ss. 149.1(2)(a) and (3)(a).
10. *ITA*, ss. 149.1(6)(a).
11. *Alberta Institute on Mental Retardation v. The Queen*, [1987] 2 C.T.C.70 (F.C.A.).
12. *Earth Fund v. The Queen*, [2003] 2 C.T.C. 10 (F.C.A.).
13. Canada Revenue Agency, Policy Statement CPS-019, "What is a Related Business?" (March 31, 2003). URL: <http://www.cra-arc.gc.ca/tx/chrts/plcy/cps/cps-019-eng.html>.
14. Canada Revenue Agency, RC4143 "Registered Charities: Community Economic Development Programs" (December 23, 1999). URL: <http://www.cra-arc.gc.ca/E/pub/tg/rc4143/rc4143-e.html>.
15. *ITA*, ss. 149.1(3)(d) and 149.1(4)(d).
16. *ITA*, ss. 110.1(1). For a thorough review of the tax treatment of corporation giving, see Theresa L. Man, "Corporate Giving: A Tax Perspective." (September 16, 2008). URL: http://www.carters.ca/pub/article/charity/2007/tlm_corpgiving.pdf.
17. On NPOs generally, see Canada Revenue Agency, IT-496R *Non Profit Organizations* (August 2, 2001), available online at <http://www.cra-arc.gc.ca/E/pub/tp/it496r/it496r-e.pdf>.
18. *ITA*, ss. 149(1)(l).
19. See, for example, *The Canadian Bar Insurance Association v. The Queen* (1999), 99 D.T.C. 653 (T.C.C.); L.I.U.N.A. *Local 527 Members' Training Trust Fund v. Canada* (1992), 92 D.T.C. 2365 (T.C.C.).
20. Canada Revenue Agency, document no. 2009-0337311E5 (November 5, 2009).