



**The fine print:
Vital information for Canadian charities operating social enterprises**

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If the title of this paper caught your attention, I am delighted. Please do read on. Share this information with your colleagues, with Board members, and staff. Refer to this document when structuring your social enterprise, or considering the launch of one.

My compulsion to write this information piece is twofold.

Since 2004, our Centre has been advocating for the creation of a separate legal structure for social enterprise in Canada. In addition to adding legitimacy and recognition to the practice, and attracting much needed capital to the sector, a new structure would also define a clear space for operating a social enterprise, a space whose rules of engagement are unambiguous¹. Also since 2004, we have been surveying the sector with respect to what structural barriers are being experienced firsthand. Most social enterprise operators report few of these.

Beginning in early 2009, our Centre was granted support by the Canada Revenue Agency (CRA) to create and deliver a workshop curriculum to small and rural charities, one that demystifies the language of CRA, and clearly explains issues

¹ This structure would differ from a typical corporation in a number of ways. Fiduciary duty would explicitly extend beyond shareholders; to community stakeholders, ecology, and more. There would be caps on dividends and interest paid to investors, to ensure that a high level of resources remain within the enterprise. An asset cap would ensure that upon wind-down, the company's assets would flow to another asset-locked entity such as a charity or another social enterprise. The tax rate may lie somewhere between zero and traditional corporate rates. Tranched or layered investment approaches would enable different investors (e.g. foundations, patient lenders, banks, the public) to derive investment payoffs at a level that each sector is accustomed to.

related to governance and compliance. Included within the curriculum is a section for charities operating social enterprise. All of our curriculum is approved by CRA, and is therefore accurate.

With charities lawyer Richard Bridge, I have now delivered 20 of these workshops to more than 500 charity and non-profit staff and volunteers across Western Canada. I am most struck by the worry that I see in most of the participants' eyes as I explain the limits on social enterprise being operated as a project of the parent charity. It is clear that they have been operating without the information that I would like to share in this paper, and it is also apparent that many charities are offside with CRA with respect to how their social enterprises are structured.

I am now convinced that the reason that few in the sector are reporting structural social enterprise barriers is that they are *not conscious of the limits that exist*. They are unaware that they may be in the position of having their charitable status suspended or revoked, should the CRA ever find out.

The information that I am about to share was delivered verbally (in a briefer version) at the 3rd Canadian Conference on Social Enterprise (Toronto, November 2009). I saw the same looks of shock on the faces of that large audience. I promised some who approached me afterwards that I would put this guidance in writing, for broader circulation.

Charities versus non-profits

First, a brief explanation of the differences between charities and non-profits. All charities are non-profits. Not all non-profits are charities. An organization must first establish itself as a non-profit before it applies to CRA's Charities Directorate to register for charitable status.

Many organizations remain as non-profits, and do not seek charitable status.

Being a registered charity means that the organization can issue official receipts for income tax purposes, to donors. Donors can then receive (personal and corporate) income tax credits or deductions for their donations. Being a registered charity also means that the organization can accept grants from other registered charities (charitable organizations and foundations: both public and private), and other 'qualified donees'.²

² Another practice that is offside with CRA is the 'lending' of a charitable number to a non-charity, or a charity acting as a 'flow-through' for non-charities. This practice is not allowed, and also undertaken often. This activity, if uncovered by CRA, can result in suspension (temporary) or revocation (permanent) of charitable status. This is the topic of another paper. To view it, please

Some also argue that another benefit of being a charity is the 'Good Housekeeping Seal of Approval' that being a charity confers. Because maintaining charitable registration generally requires much greater reporting, transparency, and government regulation than within a non-profit organization, the public could feel more comfortable with supporting charities (not to mention the 'bonus' of the official donation receipt).

Especially if an organization doesn't view itself as needing to approach the public for donations, and if it does not require project / operating grants from charities and foundations, there is little reason to become a registered charity. Certainly, the administrative burden is much heavier if the organization is a charity, and there are more restrictions with respect to what they can do and how they can do it.

A Charities Directorate representative recently stated to me that 'charitable registration is a one-way street'. This observation refers to the fact that if a charity decides to dissolve (or revert back to simple non-profit status), or if its registration is revoked by the CRA, the charity must either pay the CRA a 100% tax on its assets, or gift those assets to a qualified donee such as another charity, a foundation, or a municipality (remember, a non-profit organization is not a qualified donee). So, the decision to register as a charity must be made carefully. A reversion back to non-profit status results in a loss of the assets that it enjoyed as a charity.

Are non-profits a 'safe haven' for social enterprise?

It is generally believed that the non-profit structure is a 'safer' haven for social enterprise operation, since the limits on charities operating social enterprises abound (more in the sections below).

A recent CRA ruling has turned our assumptions about the relative safety of the non-profit organization as a safer structure for social enterprise on its head. The November 2009 ruling was in response to questions that included these:

- Can a 149(1)(1) organization [i.e. a non-profit] earn a profit?
- If the profit is intentional, but used to fund the activities of the organization, will the organization qualify for the 149(1)(1) exemption from tax?

The CRA response to the first question is yes... *but only by mistake*. The example given is if the non-profit over budgets its expenses, and turns a surplus as a

go to www.southfraser.com/cra_workshops/, fill out your information, and access the free factsheet called 'Contracting to non-qualified donees'.

result: ‘...an organization might budget with the intention of not earning a profit, but ultimately find itself with a profit because of expenses that were less than anticipated or that were reasonably expected but not actually incurred. If the original budget was reasonable, the profit earned would not, in and of itself, cause the organization to cease to be a 149(1)(1) entity.’

The response to the second question is ‘It does not matter what the profit is used for, a 149(1)(1) organization cannot have any profit earning purpose.’

My initial (i.e. generous and hopeful!) reading of the full ruling was that ‘profit’ was a reference to the organization’s ‘bottom line’ on their year-end income statement, and that, if a certain project makes a profit within the year, but it is spent on an expense within the organization in the same year, then the bottom line would be zero, and therefore acceptable to CRA.

An example given towards the end of the written ruling quells my enthusiasm. It states unequivocally that non-profits are not allowed to undertake contracts that contain ‘mark-ups’, as this clearly denotes a profit-making motive: ‘... if the organization planned to earn a profit when it entered into the contract – for example, if the contract specifically contemplated a ‘mark-up’ – the organization would not qualify for the tax exemption.’

Considering that many social enterprises are embedded within a non-profit, and earn profits to feed other aspects of the organization, we can imagine how many organizations are in the middle of real structural barrier that they simply have no awareness of.

Now... on to charities!

The CRA’s Policy Statement CPS-019 ‘What is a related business?’ (March 2003) details the nuances of when a social enterprise can be operated within a charity, and when another structural option (a taxable corporation) must be chosen. This document is ‘must’ reading for charities considering or engaged in social enterprise³.

‘Social enterprise’ has, as yet, no legal meaning in Canada. The CRA guidance therefore refers to ‘related’ and ‘unrelated’ business. Related business can be operated within a charity. Unrelated business cannot. The difference between the two is a great source of misunderstanding for social enterprise operators. Most believe that they are operating a related business. Many times, they are not. The differences between the two are clarified below.

³ It can be accessed in its entirety at www.cra-arc.gc.ca/tx/chrts/plcy/cps/cps-019-eng.html

The CRA does not consider as business (i.e. social enterprise): soliciting donations, selling donated goods (without modifying them), and fees charged for charitable programs and services. These activities can absolutely happen within a charitable organization.

An unrelated business is easiest to define by examining what it is not, that is, a 'related business'.

The Canada Revenue Agency (CRA) defines 'related businesses' as two kinds: 1) businesses that are run substantially by volunteers⁴; or 2) businesses that are linked to a charity's purpose and subordinate to that purpose.

If the social enterprise is 90% volunteer-run, then the venture is automatically delineated as a related business by CRA. The tests below for linkage and subordination need not be considered.

To expand on the second definition of related business above, 'linkage' cannot be claimed merely by the fact that the profits from a social enterprise are directed to a charity. This is called the 'destination test', and in the UK, holds as a legitimate means of proving linkage (and therefore income tax exemption)... but not in Canada!

'Linkage' to the organization's charitable purpose means that the business must meet one of the following tests:

1. Be a usual and necessary concomitant of charitable programs (e.g. a hospital parking lot, a university bookstore, a museum gift shop);
2. Be an offshoot of a charitable program (e.g. a church that records and sells choir recordings);
3. Represent a use of excess capacity (e.g. charging for parking lot use during hours of closure, or renting out event tents when not being used by the charity); or
4. Involve the sale of items that promote the charity and its objects (e.g. calendars, T-shirts, etc.).

All of the examples given above are CRA's own examples. With respect to item #3, excess capacity, it is of interest to note that CRA's examples are of excess assets, and not staff time... so we have no clarity on what percentage of staff time would be considered an acceptable 'linked' use for social enterprise activities.

⁴ This means that at least 90% of the staff of the social enterprise must be volunteers (calculated by head count, not hours).

Many organizations define 'linkage' far too loosely. They assume that if the social enterprise relates to the clients that they serve in some way, then the enterprise is a related business that can therefore be operated within the charity. This is not the case – at least one of the four areas of linkage outlined above must be demonstrated in order for the charity to use the linkage argument.

'Subordination' means that the business activity must:

1. Receive a minor portion of the charity's attention and resources;
2. Be integrated into the charity's operations, rather than acting as a self-contained unit;
3. Not dwarf the charity's decision making so that charitable goals take a backseat to the enterprise's;
4. Not involve private benefit.

All four of these areas of subordination must apply to the social enterprise.

If the social enterprise is not substantially run by volunteers, and if linkage and subordination cannot be demonstrated, then the charity is operating what CRA calls an unrelated business.

In the case of 'unrelated business', the charity is advised to establish a separate legal entity (usually a taxable corporation⁵), which must operate at absolute arms' length from the charity. Note that joint ventures are intended as an option for projects with a definite end point, not for the carrying on of ongoing business operations.

To err on the side of caution, many 'unrelated businesses' have their own Board of Directors, and staff teams. The separate legal entity that holds the social enterprise cannot benefit in any way (other than through donations: see below) from the charity that owns it. Again, to err on the side of caution, some charities enact absolute separation of staff, equipment, and sundry supplies (or a clear paper trail that shows the corporation paying fair market value for use of the charity's resources, such as rent and staff).

An unrelated business cannot be run as a 'project' of the charity, but must be established as a completely separate legal entity, remitting corporate taxes on net income derived from social enterprise activity. The corporation is allowed to

⁵ CPS-019, sections 47 and 48.

Penalties for a charitable organization or public foundation carrying on an unrelated business:

- 1st infraction: 5% penalty on gross unrelated business revenue earned in a taxation year.
- 2nd infraction: 100% penalty on that revenue and one-year suspension of tax-receipting privileges.

Private foundations are not allowed to engage in any related business activities.

donate up to 75% of its net profits to the charity, and only pays income tax on the remaining net profit after the donation is made.

Social businesses and training businesses

The 1999 guidance paper RC4143(E) from CRA entitled 'Community Economic Development Programs'⁶ includes some areas of interest for those considering certain types of social enterprise.

'Training businesses' and 'social businesses' are viewed by CRA as charitable activities, and are therefore considered to be legitimate operations of registered charities. In other words, projects that fall under the definitions of training businesses and social businesses can operate within the auspices of the charity.

From CRA's perspective, 'training businesses' and 'social businesses' are not considered as 'businesses' at all – rather, they are acceptable charitable activities.

CRA's definitions of training businesses and social businesses bear quoting in full. Yellow highlights are mine:

Training "businesses"

The purpose of these "businesses" 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, or the charity with resources. Training businesses typically share the following characteristics:

- *classroom training occurs before or accompanies the on-the-job training;*
- *the participants are employed in the business for a limited period of time;*
- *the charity offers a job placement service to help graduates of the program find work in the labour force;*
- *the proportion of workers from the target population in relation to the total number of employees is no lower than 70%, but alternative ratios may be justifiable if considerable supervision is required; and*
- *revenues derived from the business do not substantially or consistently surpass the break-even point.*

Note

"Break-even point" would include provision for a charity to build up an adequate reserve, although it would not extend to generating ongoing surpluses. In the latter case, the identity of the program as a charitable activity (as opposed to a related business) is open to question.

⁶ This document can be viewed at www.cra-arc.gc.ca/E/pub/tg/rc4143/rc4143-e.html.

Although referred to as training businesses, organizations that meet the above criteria may be conducting a charitable activity. In contrast, if an organization does not satisfy the second and fourth criteria above, it is questionable whether the organization's purpose is indeed training (charitable) as opposed to providing jobs (non-charitable). If the last criterion is not satisfied, the organization may have moved from a charitable activity into running a business. To determine whether the business activities of the organization are acceptable, the tests for related businesses would have to be considered.

Social "businesses"

Social "businesses" address the needs of the disabled and are recent equivalents of sheltered workshops. They seek to provide employment on a permanent basis, unlike training businesses that provide employment for a limited period.

Social businesses that can be registered typically share the following characteristics:

- the work is specifically structured to take into account the special needs of the workers;
- the workforce is comprised entirely of people who are physically, mentally, or developmentally challenged, with the exception of a few persons with specialized skills required for operating the business;
- the workers are involved in decision-making for the organization and sit on its board to foster their sense of competence and control over their lives;
- income derived from the business may pay the workers' wages, but the organization is subsidized, usually by government grants; and
- the organization provides training that is not only immediately job-related, but which enhances the general skills of its workers.

A social business usually provides services, but it can also manufacture articles. In the latter case, it can be structured as a workshop used either by employees of the business or by individuals working for themselves, with the organization providing technical assistance, tools, materials, and marketing.

The purpose of these workshops is to provide persons working in them with the sense of self-esteem, competence, and usefulness that comes from earning an income. The products must accordingly be sold. The organization may itself operate a retail outlet or send the products to a store in a larger centre. This store, to the extent that it only accepts products produced in the programs of a number of registered charities assisting the disabled, can itself be registered as promoting the efficiency and effectiveness of these charities.

What does an 'unrelated business' look like?
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The Community Economic Development guidance from CRA also includes a section entitled 'corporate structure for non-charitable programs'.

This section also bears quoting in full, as it gives clear direction of what 'arms length' looks like, in terms of a charity operating an unrelated business:

Corporate structure for non-charitable programs

Non-charitable programs can be "housed" in a legal entity that is separate from the charitable body. However, it is essential that there be a financial firewall between the two bodies, so that the charity's assets can in no way be used to benefit the non-charitable entity. The separate interests of the two entities should also be reinforced by such other boundaries as:

- *separate boards, or at least a situation in which the charity's board is not controlled by members from the board of the non-charitable entity;*
- *distinctive names to avoid public confusion;*
- *separate membership or shareholders; and*
- *separate equipment, personnel, and space⁷.*

Note

The charity could still control the non-charitable entity. For example, if the non-charitable entity had a three-member board, two of those members might also sit on the board of the charity and thus ensure the business was operating for the benefit of the charity. The desirable control, in this example, would be for the charity's board to number at least five persons, so that the two members sitting on both boards could not outvote those with a concern only for the charity's interests.

In conclusion

To ensure that your parent organizational structure – be it a non-profit or a charity – is not compromised by your social enterprise activities, we strongly advise the careful review of this paper, further reading of the CRA documents referenced here, and use of an experienced charity lawyer who is familiar with the world of social enterprise structural nuance.

Structural considerations should be given careful analysis in all social enterprise business planning, particularly because there is, as yet, no clear legal structure defined for social enterprise in Canada, as there is in the UK and the US⁸.

⁷ If the equipment, personnel, or space are being shared, but the business is paying for their use, this is allowable.

⁸ For more information on the development of ideas for a new structural solution in Canada, please visit www.centreforsocialenterprise.com and review the papers by Richard Bridge and Stacey Corriveau featured at the top of the home page.