

Social enterprise in Canada: Structural options

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Introduction

The past decade has seen an explosion of interest in the subject of social enterprise¹ – in Canada and elsewhere – as well as dramatic growth in the number of entities and ventures that fall within this broad category.² Social enterprise offers a range of possibilities for combining for-profit and non-profit goals, as well as the possibility of pursuing philanthropic ends without relying on the traditional means of financing charitable ventures: government grants and private donations. While the sector is still in its relative infancy, great promise has been seen by many seeking to pursue socially beneficial goals outside the traditional non-profit model (the limits of which are becoming increasingly apparent³).

The concept of “social enterprise” is itself subject to a wide range of interpretations.⁴ Some have defined it as simply the incorporation of greater fiscal discipline into the operation of charities and non-profits. More commonly, however, the term refers to the use of revenue-generating business-like activities to accomplish, at least in part, a socially beneficial end.⁵ This definition is itself very broad, and it is clear that there are many different structures that fit within this basic concept – from business corporations designating a portion of their profits for charitable or social ends, to charities and non-profits establishing subordinate for-profit entities or operations to finance their non-profit purposes, to charities and non-profits conducting for-profit operations that directly advance their community or philanthropic purpose.

In many ways, the law in Canada is still catching up to the range of social enterprise models that have emerged. While other jurisdictions like the U.K. and certain U.S. states have developed specialized corporate forms intended to accommodate this unique category of venture, Canadian law remains largely divided between traditional non-profit and for-profit models.

Nonetheless, there are a variety of available options by which social enterprises in Canada can be structured, and most forms of social enterprise can be accommodated through one or more of these approaches. The optimal structure will vary from case to case and depends on the goals and priorities of the individual or organization engaging in the venture. It is vital that individuals and organizations engaging in social enterprise decide upon a structure based on these considerations, rather than allowing the structure to dictate the path that the enterprise takes.

This article will consider various structural options for social enterprise from the perspective of a social entrepreneur contemplating a new social venture. It will address the issues that should be considered before deciding upon a structure, and will then describe available structures and how different structures will suit different combinations of priorities. This article adapts for Canadian readers the work of Jim Fruchterman, who discussed structural options for social enterprise from this perspective in the U.S. context.⁶ After reviewing the preliminary considerations that Fruchterman emphasizes as crucial before making structural decisions, we will then review some of the structural options available in Canada, and the pros and cons of each.

¹ The terminology in this area is not entirely settled, and the terms “social enterprise”, “social purpose business” and “social venture” are sometimes used as distinct concepts and sometimes interchangeably. The emerging terminology favours using “social enterprise” when charities and non-profit organizations earn income through business-like activities to accomplish a social mission, “social purpose business” to refer to for-profits with a social mission, and “social venture” as an umbrella term encompassing both of these concepts. In this paper, while we have tried to use this terminology where possible, we have not strictly maintained this nomenclature. Given that “social enterprise” is still frequently used as an umbrella term, we have used it in this fashion in this paper.

² Annie Malhotra, Heather Laird, & Adam Spence. *Social Enterprise Census 2010* (Social Venture Exchange and Ontario Nonprofit Network, December 2010). The Census notes that 50% of all social enterprises operating in Ontario were established in the last five years, a trend that appears to be supported by the work of Imagine Canada and others observing this field.

³ See, for example, Elizabeth Mulholland, Matthew Mendelsohn & Negin Shamshiri, *Strengthening the Third Pillar of the Canadian Union* (Mowat Centre for Policy Innovation at the University of Toronto, March 2011).

⁴ For a summary of the various meanings attached to the concept of “social enterprise”, see Johanna Mair, Jeffrey Robinson & Kai Hockerts, eds., *Social Entrepreneurship* (New York: Palgrave MacMillan, 2006), 4-6.

⁵ This is essentially the definition used by the Canadian Task Force on Social Finance in 2010: “Social enterprise is generally understood to mean any organization or activity that uses the market-oriented production and sale of goods and/or services to pursue a public benefit mission.”

⁶ Jim Fruchterman, ‘For Love or Lucre,’ *Stanford Social Innovation Review* (Spring 2011), 42.

Preliminary Considerations

Frchterman lists four basic issues that prospective social entrepreneurs must address before deciding on an appropriate structure. Some of these issues relate to the basic goals and vision underlying the proposed enterprise, while others relate more to the practical requirements – financial and otherwise – of the activities to be carried on. Falling into the first category are the issues of motivation and control. The second category considers the issues of the market in which the enterprise will operate and the capital requirements of the operation.

(a) Motivation

This issue addresses the question of what the venture in question is fundamentally intended to accomplish. Is the primary goal of the venture to generate private profit or to further a social mission, and how central is the social mission to the organization? While these goals are not mutually exclusive, their relative importance will influence the optimal structure as they will often come into conflict during the life of the enterprise.

Like start-up businesses, many new social ventures will ultimately fail to achieve sustainability.⁷ If the venture struggles to generate revenue, this will lead inevitably to questions about the extent to which the operations of the venture can be changed or new revenue opportunities pursued to improve the financial sustainability of the enterprise. These options may conflict with the social purpose of the venture or may threaten to shift the focus of the organization away from its social mission. Given this potential tension, it is vital to have a clear guiding vision of the factors that will determine the extent to which the operations of the venture can be changed to accommodate new sources of revenue. This factor is also important when deciding whether or how long a venture should continue to operate at a loss.

Thus, prospective social entrepreneurs need to ask themselves how they will define success. Will it be personal wealth or making a positive difference in the community? Consider also how outside pressures will influence the definition of success. If outside investors will be involved, there may be pressure to define success in terms of the returns delivered to them. How important is the social mission to the investors? If the principal operator or investor in the enterprise is a charity, then the social mission must be paramount.

Related to the question of the venture's fundamental purpose is the question of the personal (or institutional) motivation of the social entrepreneur(s) and investor(s) who will drive and finance the venture. As with any business venture, the start-up of the business will likely entail sunk costs that cannot be recouped if the business fails and which may never be recouped even if the venture achieves sustainability. Investors in the enterprise must decide whether this is acceptable. They must also decide, again, on whether success will be defined primarily in terms of financial or social returns. If financial return is the primary goal of the venture – either as a source of personal profit or as a method of funding a related charity – then the optimal structure may be one that affords greater flexibility to adapt to changing financial conditions and to pursue economic opportunities. If the social goal is paramount, then investors may wish to choose a structure that ensures that the social purpose remains the dominant factor in operational decision-making. Social entrepreneurs are generally striving to achieve both social impact and financial return, but for the purpose of determining the appropriate corporate structure, it is recommended that one motivation be identified as primary, even if only slightly so.

(b) Control/Governance

The question of how and by whom control over the venture will be held is central to the structural decision. Whereas there is considerable flexibility in how a for-profit organization may be controlled – particularly one that is not publicly traded – entities that benefit from favourable tax treatment are generally subject to greater limitations on the extent to which a single person or related group may control the organization and on the factors that must be considered when making operational decisions.

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Prospective social entrepreneurs will therefore need to consider the extent to which they can operate and fund the venture themselves, and the extent to which it may be necessary to share control with outside investors or others. The greatest flexibility comes when a social entrepreneur or founding organization can retain complete control over the operational decisions. As soon as control is split, different interests and priorities may come into competition. Prospective entrepreneurs should consider the potential for damage to existing relationships when such differences arise.

⁷ Seedco Policy Centre, *The Limits of Social Enterprise: A Field Analysis & Case Study* (June 2007), 5.

Legally, a for-profit corporation is controlled by its shareholders, who are responsible for the election of the board of directors and whose economic rights in the entity are protected by statute. A not-for-profit corporation is similarly controlled by its members, in that the members are responsible for the election of the board of directors. However, the members do not have an economic interest in the entity and thus the character of the control is somewhat different.

If investors become shareholders or members of the corporation, consider how this will affect the operation of the venture. If they are able to elect members of the board sympathetic to their position – which may not align with that of the founder – or if they join the board themselves, they may be in a position to influence the corporation. It is important to consider at the outset how much formal control the founder is willing to share.

Likewise, it is also important to consider that, depending on the structure of the venture, control may be shared not only with other investors or stakeholders but also with the public interest. Charities and non-profit organizations are subject to strict limits on the purposes for which their funds may be spent, and the public interest is required to be foremost in the decision-making of the organization. This can entail additional regulatory supervision over the operations of the organization.⁸ It is important to select partners who understand this requirement and who are committed to the furtherance of the organization's social purpose.

The issue of transparency is also a factor to be considered. The level of public disclosure of the organization's finances and operations, as well as information about the directors and officers, varies depending on the structure and tax status of the organization. A registered charity, for example, must make annual filings containing detailed information concerning its activities and finances.⁹ It must also disclose the salary ranges of all its employees, and the names of its directors. This information is publicly available. Accordingly, social entrepreneurs must consider the extent of disclosure with which they are comfortable.

(c) Market

It is important that prospective entrepreneurs consider and understand their market. This requires consideration of the customers, the value proposition, and the competition. As with any business, the success of the venture will depend on understanding and thinking through these issues.

Understanding the customer is perhaps the most important consideration. What need is the venture intended to fill? What community will be served? What expertise will be required regarding the needs of the customers, and how will this expertise be accessed? Are the customers who will use the product or service provided by the venture the same people who will pay for it? If those funding the venture will be different from the end-users, how will these funders be attracted to the venture?

Related to this, it is important to consider the size of the market and the potential for profit. The scale of the operations, as well as the relative ease with which the venture is anticipated to be profitable, will influence whether to structure the venture as a for-profit or non-profit. Generally speaking, the larger and more readily profitable the proposed venture, the more a for-profit structure may make sense. If, by contrast, it is expected that the venture will be difficult to make sustainable in absence of support through donations and grants, then a non-profit structure may be more appropriate.

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It is also important to understand the competition that the venture will face. Even if there are no other providers of the goods or services that the venture intends to provide or sell, other players in a market may compete for the dollars that might otherwise be spent on the venture's products, and the nature of this competition may influence the selection of an appropriate structure. For example, if a for-profit business is seen as exploiting a community, there may be space for a non-profit to enter the market. By contrast, if a non-profit organization is seen as insufficiently responsive to the needs of the community, this may present the opportunity to enter the market using a business approach that places a business-like emphasis on customer service.

Finally, the value proposition of the venture must be addressed. How will the product or service to be provided be differentiated from those already available in the market? This question is important when determining the structure of the venture. If the venture intends to sell goods or services that are already available in the marketplace, then this will create an additional challenge in having the venture registered as a charity or maintain status as a non-profit organization. Charities and non-profits are subject to restrictions on the types of business activities that they may

⁸ The public interest in charities is regulated by the Attorney General of the relevant province. In some instances, the Attorney General's authority to regulate charities is delegated to the Public Guardian and Trustee. Ontario is a notable jurisdiction in which the use of charitable property is regulated by the PGT.

⁹ Charities are required to file form T3010 each year, which contains detailed disclosures regarding the operations and finances of the charity. A copy of this form is available at <http://www.cra-arc.gc.ca/E/epbg/tf/t3010-1/README.html>.

carry out, and one of the factors which may be relevant to the Canada Revenue Agency (“CRA”) when evaluating whether a revenue generating activity of a charity or non-profit is acceptable is whether it competes with products and services provided by for-profit organizations.

(d) Capital

One of the fundamental determinants of whether a venture will be structured as a for-profit or non-profit are the capital requirements of the enterprise. Will the venture be funded by investors who expect to be repaid or receive a return on investment? If so, it will be necessary to determine the likelihood of generating sufficient returns to pay such investors. If they are unlikely to be repaid, then it will be necessary to determine whether the venture can be funded entirely out of the funds of the founder, or whether traditional sources of non-profit funding – grants and donations – will need to be factored into the business model.

Prospective social entrepreneurs need to consider their capital needs both at start-up and on a going-forward basis. The funds needed at start-up may influence the structure of the venture. If the venture can be initiated for relatively low costs, then there will be greater flexibility in terms of the structure that can be employed. If, however, the venture will require significant start-up costs, it may be necessary to prioritize flexible financing when determining the structure of the enterprise. Likewise, it is necessary to consider the need to access outside capital to grow the business. Even if the business becomes profitable or sustainable, it may not generate sufficient revenue to finance the desired growth or expansion of the operations. If this is so, then the ability to access outside capital will again be relevant. Generally speaking, greater needs for capital and financing flexibility – and in particular the need to be able to issue share capital – will suggest a for-profit structure.

When considering the capital requirements for the venture, it is particularly important to determine the likely ability of the venture to obtain loans. Non-profit organizations and charities cannot generally access share capital and so must rely on debt financing (in addition to grants and donations) as a means of attracting capital. Thus, if a social entrepreneur is leaning towards structuring a venture as a non-profit, it will be important to consider whether the venture will hold assets that can be borrowed against, making it a better candidate for commercial loans.¹⁰ To the extent that a charity or non-profit organization may wish to make loans to other non-profits – either as a way of raising funds or to further a social purpose – the organization will need to be aware that any such loans must comply with strict requirements if made at below-market rates of return.¹¹

Prospective entrepreneurs should also consider the significance of an exemption from income and property tax in their proposed venture. Charities and non-profit organizations benefit from a general exemption from income tax.¹² Some also may qualify for tax exemptions from taxes on real property. These exemptions are attractive to the extent that an organization will generate a significant surplus from operations or will hold significant amounts of property that would otherwise be subject to tax. However, if no such profit is expected and the organization does not anticipate holding significant amounts of real property, then the tax exemption granted to non-profits under the *Income Tax Act* or property tax legislation is of less importance. While such tax exemptions are not the only factor that make status as a charity or non-profit organization attractive – the ability to present the organization as a non-profit or charity and potentially to issue tax receipts for donations are also significant – the absence of profit and property will diminish the importance of maintaining tax-exempt status.

¹⁰ Some organizations are also experimenting with other forms of debt financing. The Centre for Social Innovation in Toronto, for example, has developed a form of Community Bond to finance certain projects. These are RRSP eligible investments allowing individuals and organizations to invest in CSI, earning 4% rates of return over a five-year term. See <http://socialinnovation.ca/communitybonds>.

¹¹ Such investments by charities are subject to rules under both the *Income Tax Act* and under provincial trust law. CRA sets out its policies regarding Program Related Investments in RC4143 *Registered Charities: Community Economic Development Programs* (December 23, 1999): <http://www.cra-arc.gc.ca/E/pub/tg/rc4143/rc4143-e.html>. Essentially, CRA takes the position that investments in non-qualified donees must be made at market rates of return. Charities must also always consider the investment standards prescribed for trustees of charitable property – they must “exercise the care, skill, diligence and judgment that a prudent investor would exercise in making investments” (for example, s. 271 of the *Trustee Act*, R.S.O. 1990, c. T.23). Failure to meet these standards can result in sanctions from the Public Guardian and Trustee.

¹² *Income Tax Act*, R.S.C. 1985 c.1 (5th Supp.) [ITA] at 149(l)(f) and (l).

Structural Options

Having considered these issues and preliminary considerations, a social entrepreneur can then turn to the question of how best to structure the enterprise from a corporate and tax perspective. As noted at the outset of this article, Canadian law is in many ways still catching up to social enterprise as a distinct form of operational model. Unlike the U.K. and certain U.S. states, Canada has not developed a distinct legal regime to govern this form of activity, nor specialized corporate forms to accommodate it (though efforts have been made to encourage provincial governments to develop such specialized forms).¹³ Thus, social entrepreneurs must adapt the available for-profit and non-profit structures to the particulars of the enterprise. Each structural option has pros and cons, and the optimal form will vary according to the considerations and priorities discussed above.

In what follows, we will review the main structural options available in Canada to social entrepreneurs, and will discuss the advantages and disadvantages of each. This is not intended as a detailed or exhaustive review of the legal and tax implications and restrictions applicable to each approach, but rather a general overview of how the issues addressed above may play out in the context of different structures.

(a) For-profit structure

Although not specifically designed for social purposes, for-profit entities can make an effective vehicle for carrying out a social enterprise. This could take the form of a business corporation incorporated under the Canadian Business Corporations Act or provincial equivalent, but could also be structured as a sole proprietorship, a partnership or a business trust (though these latter approaches are less common).

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Depending on the priorities of the enterprise, the use of a for-profit structure has significant advantages, the main one being flexibility in the types of activities that the enterprise may pursue and the ways in which it can attract capital. This is balanced against the absence of preferential tax treatment and

the potential for conflict between the intended social mission and the for-profit form.

Some of the principal advantages of a for-profit form (we use a business corporation as an example) are:

- **Flexibility in activities.** Under modern business corporation statutes, a corporation, legally, has all the capacity, rights, powers and privileges of a natural person and can essentially carry on any type of activity.¹⁴ Thus, unlike registered charities and non-profit organizations, which are required to formally limit the activities that they may carry on, a business corporation can pursue any type of revenue opportunity that may arise, and is not limited to charitable, social or non-profit purposes. Business corporations are thus more adaptable to changing financial circumstances than are non-profit organizations.
- **Flexibility in raising capital.** Business corporations have considerably greater flexibility than do non-profit organizations in the ways that they can raise funds. They can issue both shares and debt instruments, and have a greater ability than non-profits to provide returns on investment that make it easier for the corporation to attract investors. The terms of investment (e.g., share conditions, terms of debt) are themselves flexible and can be tailored to accommodate multiple bottom lines.
- **Flexibility in dealing with assets/revenue.** Unlike registered charities and non-profit organizations, which are required to use their assets only in specific permitted ways, business corporations can essentially do as they choose with their assets and revenue. This can include making grants to charities, carrying out social activities, paying dividends and returns to investors, or any combination of the above, in whatever proportion the corporation chooses. Note, too, that corporations can significantly reduce tax payable through charitable giving, such that the absence of tax exempt status becomes less of an impediment than might originally have been thought.¹⁵
- **Ease of conversion to non-profit.** Generally speaking, it is easier to convert a for-profit entity into a non-profit entity than *vice versa*. A business corporation can convert to a non-profit organization, or transfer its assets to a non-profit, upon obtaining shareholder approval. By contrast, and as discussed below, a registered charity cannot transfer its assets outside the charitable sector and cannot

¹³ For example, the B.C. Government is actively considering the enactment of changes to their *Business Corporations Act* which would enable the incorporation of a hybrid form of corporation similar to the Community Interest Corporations in the U.K.

¹⁴ For example, Canada Business Corporations Act, R.S.C. 1985, c. C-44, s. 15.

¹⁵ Corporations can deduct up to seventy-five percent 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: ITA, ss. 110.1(1). For a detailed review of the tax treatment of corporation giving, see Arthur Drache, Robert Hayhoe & David Stevens, *Charities Taxation Policy & Practice*, looseleaf (Toronto: Thomson Carswell) at 20.11.

easily convert into a for-profit entity without essentially transferring the whole of its assets to other registered charities or qualifying recipients.

- **Ease of wind-up.** Provided that the corporation pays its creditors, the wind-up of the corporation and distribution to shareholders is relatively straightforward. The process for non-profits, by contrast, is more protracted, with greater restrictions applying to the distribution of assets.
- **Familiarity of structure.** There is no shortage of legal, tax, accounting and business expertise regarding the operation of a business corporation (or other for-profit forms), and the rules regarding the governance and operation of these entities are well established. There is also considerable material available setting out best practices with respect to corporate governance. This allows for more certain tax and business planning.

The disadvantages of the for-profit approach to a social enterprise include:

- **No preferential tax treatment.** Business corporations are subject to both federal and provincial income tax, provincial property tax, and supplies by for-profits are generally GST/HST taxable. They cannot issue official donation receipts for public donations and do not benefit from the general tax exemption provided to charities and non-profit organizations. The significance of this disadvantage varies depending on the extent of the corporation's expected profits and property holdings.
- **Cannot receive funds from charitable sector.** Generally speaking, registered charities cannot contribute funds to a for-profit entity,¹⁶ except through market-rate investments. A charity cannot, for example, transfer its funds to a for-profit entity for the purpose of establishing an endowment fund. This limits the corporation in its ability to attract funding from the charitable sector.
- **Responsibility to shareholders.** To the extent that a corporation has issued shares as a means of raising capital,

it may be subject to influence or outright control by its shareholders, for whom return on investment may be paramount. In most jurisdictions, shareholders have a range of remedies available to the extent that a court concludes that their interests as shareholders have been prejudiced.¹⁷ This gives rise to a natural pressure in favour of prioritizing financial return that may come into conflict with the social mission of the entity. Note, too, that this pressure to generate profit is likely to cause an increase in the tax liability of the corporation, making the tax status of the entity a more significant consideration.

- **No formal social purpose.** Legally, most business corporations will not be established with any formal legal limitations on the types of activities that they may conduct. Indeed, this flexibility in available activities is a prime advantage of the for-profit form. However, this means that the pursuit of the social purpose, and the maintenance of a focus on social benefit, is dependent on the leadership of the corporation. The absence of a legally enforced social purpose may create marketing or public relations difficulties to the extent that the enterprise wishes to present itself as a social enterprise.

(b) Registered charity

If for-profit entities occupy one end of the structural spectrum – enjoying minimal tax benefits but maximum operational flexibility – registered charities occupy the other. They benefit from the most favourable tax treatment extended to non-profit entities in Canada and are accordingly subject to more restrictions on the purposes and activities that they may carry out. Charities are required to be constituted for exclusively charitable purposes and to carry on exclusively charitable activity. Among the restrictions applicable to registered charities are limits on the types of business activities in which they may engage¹⁸ and the types of investments they may make.¹⁹ Charities are also subject to restrictions on the entities to which they may transfer funds²⁰ and on their ability to provide financial returns on public investment.²¹

¹⁶ Registered charities are permitted to grant funds or resources only to "qualified donees," a term defined under the *ITA*. This category is limited to other registered Canadian charities, RCAAAs, and certain other narrow categories of organization. See footnote 20 for a complete list. For-profit entities are generally excluded from the definition.

¹⁷ Shareholders may, depending on the circumstances, avail themselves of the oppression remedy, derivative actions, and compliance orders. For a discussion of these, see Kevin P. McGuinness, *Canadian Business Corporations Law*, 2nd ed. (LexisNexis Canada Inc., 2007), chapter 13.

¹⁸ For a discussion of CRA's policies on acceptable versus unacceptable business activities by registered charities, see CRA Policy Statement CPS-019, "What is a Related Business?" (March 31, 2003) available online at: <http://www.cra-arc.gc.ca/chrts-gvng/chrts/plcy/cps/cps-019-eng.html>.

¹⁹ See note 10 above.

²⁰ Charities can make outright transfers of funds only to "qualified donees," which definition includes a registered charity; a registered Canadian amateur athletic association; a housing corporation resident in Canada constituted exclusively to provide low-cost housing for the aged; a Canadian municipality; the United Nations and its agencies; a university that is outside Canada that is prescribed to be a university the student body of which ordinarily includes students from Canada; a charitable organization outside Canada to which Her Majesty in right of Canada has made a gift during the fiscal period or in the 12 months immediately preceding the period and Her Majesty in right of Canada or a province. Failure to abide by this rule is grounds for the revocation of charitable registration (*ITA*, ss. 149.1(2)(c), (3)(b.1), (4)(b.1)).

²¹ Charities are precluded from making any income payable to, or available for, the benefit of any proprietor, member, shareholder, trustee or like official (*ITA*, ss. 149.1(1) "charitable organization", "charitable foundation").

“Registered charities benefit from the most favourable tax treatment extended to non-profit entities and are, accordingly, subject to more restrictions.”

Some forms of social enterprise are well-suited to being carried out directly by registered charities. Social businesses, for example, that are expressly formed for the purpose of providing employment to hard-to-employ persons (e.g., those suffering from drug and alcohol addiction, developmentally challenged persons, etc.) are recognized by CRA as a charitable activity notwithstanding its profit component (although such businesses are typically subsidized by government grants or private donations).²² It is also considered charitable to provide “training businesses” designed to give on-the-job training in vocational skills or more general training in work skills that enhances a person’s employability.²³ Charities have also historically carried on certain types of revenue-generating activities (such as universities charging tuition, hospitals charging health care fees, and museums and galleries charging admission) without question. However, these programs (and a few others like them) are the exceptions to the rule, and charities are generally not permitted to engage in activities in which substantial profit will be realized.

The advantages of conducting social enterprise through a registered charity are:

- **Ability to issue donation receipts.** Individual and corporate donors to a registered charity can receive official donation receipts enabling them to receive tax recognition for charitable gifts. A range of personal and corporate gift planning options exist which involve donations to registered charities. This gives charities a substantial advantage in attracting public donations. To the extent that the social enterprise needs start up capital, the ability to attract such donations to support the initiative is very attractive.
- **Ability to receive funds from other registered charities or qualified donees.** Existing registered charities can grant only to other registered charities and qualified donees. If the social enterprise is in a registered charity, it can access such grants to support the initiative.
- **Favourable tax treatment.** Registered charities are generally exempt from income tax, may be exempt from property tax,

and most supplies by charities are exempt from GST/HST.²⁴ To the extent that a charity may realize profits from its activities, these exemptions are highly valuable.

- **Legally enforced social purpose.** As noted, charities are legally required to be constituted for exclusively charitable purposes and to conduct exclusively charitable activities. Although this restricts the activities that a charity may conduct, it assures the public that funds contributed to the charity will be used for a charitable purpose. This may be valuable to entrepreneurs wishing to emphasize the social mission in marketing the enterprise.
- **No investors with conflicting priorities.** Charities are typically constituted as non-share capital corporations, which are controlled by members committed to the social purpose of the corporation. Unlike shareholders in a business corporation, members of non-share capital corporations do not have a direct financial stake in the enterprise. This means that there is less likelihood of conflict between a for-profit impetus and the organization’s social mission.

The disadvantages of registered charities as a vehicle for social enterprise include:

- **Restrictions on business activities.** Although having a legally-enforced social purpose may benefit a charity in terms of its ability to hold itself out as a social benefit enterprise, this restriction significantly limits the types of business-like activities that may be carried out by a registered charity. Charitable organizations and public foundations are limited to carrying on “related businesses”, which includes businesses that are run substantially by volunteers or are linked and subordinate to the charity’s purpose.²⁵ Whether an activity is linked and subordinate to a charity’s purpose is a question of fact. Historically, this has been interpreted relatively narrowly, and revenue-generating activities that are in no way linked to the charity’s purpose are off-limits.²⁶ It is not sufficient that the profits generated by a business activity will go towards the charity’s charitable purpose. Thus, charities lack the flexibility of a for-profit to pursue a wide range of revenue opportunities.
- **Limited to traditional funding sources.** Generally speaking, charities are limited in their ability to raise capital other than through public donations, government grants, and grants from other registered charities. Charities cannot issue share

²² RC4143, *supra*, at 5.

²³ *Ibid* at 6.

²⁴ With respect to GST/HST taxation of charities, see Canada Revenue Agency, RC4082 *GST/HST Information for Charities* (June 29, 2010), available at <http://www.cra-arc.gc.ca/E/pub/gp/rc4082/rc4082-e.html>

²⁵ See note 13 above.

²⁶ *Earth Fund v. The Queen*, [2003] 2 C.T.C. 10 (F.C.A.).

capital and are subject to restrictions in the *ITA* on their ability to incur debt.²⁷ This makes it more difficult for charities to offer varied investment options and returns on investment sufficient to attract non-donated capital. That said, charities can generally structure debt instruments so as to provide adequate returns to attract outside investment capital.

- **Assets locked in Canadian charitable sector.** As noted, charities are precluded from making outright grants or property transfers to entities that are not qualified donees. For the most part, this consists of other registered charities. This means that charities cannot easily convert to a for-profit form or provide funding to for-profit organizations (even to pursue social goals). Funds can only be provided to non-qualified donees if invested in market rate investments or by using special intermediary structures establishing a charity's ongoing direction and control over the use of its assets by a third party.²⁸ These structures are often unfamiliar to the operators of charities and impose compliance difficulties.
- **Disbursement quota.** Charities are subject to an annual spending requirement, referred to as the disbursement quota. Charities must disburse annually on charitable activities or gifts to qualified donees at least 3.5% of all investment properties held by the charity.²⁹ Failure to meet the disbursement quota can result in revocation of registration.³⁰ Meeting this requirement must be taken into account when charities are planning their revenue-generating activities.
- **Additional reporting.** Charities are subject to relatively stringent reporting requirements and must file annual returns – which are publicly available – setting out the charity's operations and financial activities for the previous year.³¹

(c) Non-profit organization

Another structural option that is sometimes considered for the operation of a social enterprise is a non-profit organization (“NPO”). NPOs are organizations that are

established for exclusively social purposes – including social welfare, civic improvement, pleasure or recreation and any other purpose other than profit – but are not charities.³² They benefit from a general exemption from income tax, but are not eligible to issue donation receipts to donors. As they are typically established as non-share capital corporations, it is difficult for investors to invest in a non-profit entity in the same manner as they would invest in a for-profit business corporation. This limits the ability of NPOs to raise capital from non-traditional sources.

Historically, successful social enterprises have been conducted using the NPO structure.³³ Recently, however, NPOs have been the subject of increasing CRA scrutiny and subject to an increasingly strict interpretation of the requirement that an NPO must operate for any purpose other than profit. In a recent technical interpretation,³⁴ CRA has taken the position that to the extent that an NPO budgets for a surplus in a given year, that NPO will no longer meet the requirements for tax-exempt status. Furthermore, CRA has suggested that an NPO may be offside the rules if any discrete activity generates a surplus, even if the organization as a whole operates on a cost recovery basis.³⁵ Although we question the correctness of these interpretations – why create an exemption from income tax for an entity that is never capable of earning a profit? – it is clear that until this issue is resolved, NPOs may be less attractive as a social enterprise structure.

“Non-profit organizations benefit from a general exemption from income tax but are not eligible to issue donation receipts to donors.”

Subject to this uncertainty, however, there are several potential advantages to using an NPO to conduct social enterprise activities:

- **Tax exempt status.** As noted, NPOs are generally exempt from income tax, may be exempt from property tax, and supplies by NPOs may be GST/HST exempt.³⁶

²⁷ The Act provides that charitable foundations are prohibited from incurring debt “other than debts for current operating expenses, debts incurred with the purchase and sale of investments and debts incurred in the course of administering charitable activities” (*ITA*, ss. 149.1(3)(d) and (4)(d)). While it is true that debt incurred to finance a social venture would likely fall within one of these exceptions, the need to be aware of this restriction complicates the issuing of debt by charities.

²⁸ This issue arises most frequently in the context of Canadian charities conducting activities outside Canada using foreign intermediaries. See Canada Revenue Agency, *Canadian Registered Charities Carrying Out Activities Outside Canada* (July 8, 2010).

²⁹ *ITA*, *supra*, ss. 149.1(1) “disbursement quota”. The disbursement quota was, until recently, considerably more onerous, requiring charities to disburse 80% of all receipted gifts and gifts from other charities received in the previous year. As a result of the 2010 Federal Budget, the disbursement quota obligation was greatly simplified and is now largely limited to the 3.5% disbursement requirement.

³⁰ *ITA*, *supra*, ss. 149.1(2)(b), (3)(b), (4)(b).

³¹ See note 6 above.

³² *ITA*, *supra*, ss. 149(1)(l). This paragraph specifically provides that to be tax exempt, the NPO must not, in the opinion of the Minister, be a charity.

³³ See, for example, *Gull Bay Development Corp. v. R.* (1983), 84 D.T.C. 6040 (F.C.T.D.).

³⁴ CRA document no. 2009-0337311E5 (November 5, 2009);

³⁵ CRA document no. 2009-0348621E5 (December 15, 2009).

³⁶ With respect to GST/HST taxation of NPOs, see Canada Revenue Agency, *RC4081 GST/HST Information for Non-Profit Organizations* (July 19, 2010), available at <http://www.cra-arc.gc.ca/E/pub/gp/rc4081/rc4081-e.html>.

- **Legally enforceable non-profit purpose.** NPOs are required to be constituted for exclusively non-profit purposes and can thus represent themselves publicly as having an exclusively social mission.
- **Flexibility in purposes/activities.** NPOs have greater flexibility than registered charities in the types of purposes they may be constituted to pursue. They must limit themselves to exclusively non-profit purposes, but beyond this, the *Income Tax Act* does not impose further restrictions. Thus, NPOs can pursue a range of activity that would not meet the definition of charity at common law. The provision of recreation, for example, would be one such purpose.
- **Grant-making flexibility.** Unlike registered charities, NPOs are not limited in the types of entities to which they may transfer funds. They may transfer funds to charities, other NPOs, and for-profit corporations provided such transfers are consistent with their non-profit purpose. This allows them to work more easily alongside non-charities and for-profit entities in furtherance of a social purpose.
- **No investors with conflicting priorities.** Like registered charities, NPOs are typically constituted as non-share capital corporations and do not have shareholders with a direct financial interest in the venture. Thus, there are relatively limited concerns regarding tension between the social mission and an impetus to generate profit.

The disadvantages of the NPO structure include:

- **Donations to NPOs are not tax deductible.** Unlike donors to registered charities, donors to NPOs do not receive tax recognition for such gifts. This limits the ability of NPOs to raise funds from traditional sources (grants and donations).
- **Limits on ability to raise capital.** NPOs are subject to many of the same limits as registered charities in the ways they can raise capital. They cannot generally issue shares, and none of the income of the organization can be made available to the organization's members. This means that NPOs are arguably the most limited in their ability to raise funds from the public in that they cannot issue receipts to attract outright donations and are limited in their ability to attract investors with the promise of returns on investments. Furthermore, an NPO is not a qualified donee and thus cannot receive grants from registered charities.
- **Regulatory uncertainty.** As noted, the rules within which NPOs must operate are currently in flux, with at least some at CRA taking a hard line on the ability of NPOs to carry on any profit-

generating activities. Until this issue is resolved, the use of NPOs to carry on social enterprise activities that are designed to generate self-sustaining revenue is considerably more risky in that it cannot be assured that the NPO will maintain its tax-exempt status. A CRA assessment that successfully challenges a claim for NPO exempt status could result in retroactive taxation of income earned by the organization in the years that it did not qualify for the NPO exemption.

(d) Co-operative

Another option by which certain forms of social enterprise may be structured is the co-operative corporation, often referred to simply as a "co-operative."³⁷ Co-operatives are a special form of corporation incorporated under legislation specific to co-operatives,³⁸ rather than under a general corporations statute. They are membership corporations, owned and democratically controlled by the members and generally designed to operate for the benefit of the members through the use of the co-operative's services. Co-operatives are required to operate on a "co-operative basis," which requires that they have several statutorily mandated structural elements that distinguish them from typical share capital or non-share capital corporations. In summary, these are as follows:

- **One member, one vote.** Each member in a co-operative has one vote on corporate decisions, regardless of the amount invested. This is distinct from business corporations, in which the extent of shareholdings determines a shareholder's proportional representation in corporate decisions.
- **No member votes by proxy.** Co-operatives are intended to operate through the active participation of their members. Thus, members must attend meetings in person and cannot vote by proxy (though it is possible in some cases for groups of members to appoint delegates to represent groups of members in a particular region).
- **Limits on interest and dividends.** Interest on loan capital and dividends on share capital are subject to a percentage fixed by regulation or the co-operative's constating documents.

"Co-operatives are membership corporations, owned and democratically controlled by the members and designed to operate for the benefit of members."

- **Re-investment of surplus for social purposes.** Co-operatives are required to operate on as near a cost-recovery

³⁷ An overview of co-operatives, along with links to resources, is available from the Canada Business Ontario at <http://www.cbo-eco.ca/en/index.cfm/guides/co-operatives-info-guide/>.

³⁸ For example, *Canada Cooperatives Act*, S.C. 1998, c. 1; *Co-operative Corporations Act*, R.S.O. 1990, c. C-35; *Cooperative Association Act*, S.B.C. 1999, c. 28.

basis as possible after providing for reasonable reserves and the payment of authorized interest and dividends, and to use any surpluses for the improvement of the co-operative's services to its members or donate these surpluses for the general welfare of the community.

- **Patronage dividends.** Co-operatives are permitted to pay "patronage dividends" to its members – over and above the statutorily-capped interest and dividends – in proportion to the volume of business the members have done with or through the corporation. Such patronage dividends are generally deducted from the co-operative's income.

There are various sub-categories of co-operatives, including financial co-operatives (which offer financial, loan, investment and insurance services to their members); consumer or service co-operatives (which provide their members with goods or services for their personal use); and worker co-operatives (which exist to provide employment opportunities to their members).

Given that co-operatives contemplate a mixture of economic benefits for members as well as the potential for more general community benefits, they may be a suitable structure for certain types of social enterprise. Particularly to the extent that a social enterprise is intended to focus its benefits on a particular community – for example, through the provision of employment or better community services – co-operatives may be an appropriate vehicle.

Some of the advantages of the co-operative form as a vehicle for social enterprise include:

- **Legally enforced requirement for operation on co-operative basis.** Co-operatives are legally required to operate on as near a cost-recovery basis as possible, reinvesting any surpluses in their core services and the general welfare of the community. This allows co-operatives to hold themselves out as having a community-benefit purpose, which aids in marketing.
- **Ability to attract outside capital.** Co-operatives are generally designed on the assumption that the majority of the organization's capital will come from the members. However, co-operatives are permitted to issue shares and loans to non-members, with the promise of at least a limited financial return on investment. This aids in attracting capital from outside the membership structure if necessary.
- **Flexibility in activities.** Subject to a requirement to operate on a co-operative basis, co-operatives are subject to few restrictions on the types of activities that they may carry out. Indeed, the requirement to operate on a co-operative

basis pertains more to the use of the proceeds of an activity rather than the specifics of the activity itself. This makes co-operatives more flexible than charities or NPOs in how they act.

Some of the potential disadvantages of the co-operative form include:

- **No preferential tax treatment.** Co-operatives do not benefit from a general tax exemption or the ability to issue donation receipts. Although it is possible for a co-operative to be registered as a charity or qualify as an NPO, the focus on member benefits in the co-operative structure makes this challenging. In order to qualify as a charity or NPO, a co-operative would need to adopt additional restrictions on its permitted purposes and activities, as well as to restrict itself from making its income available to its members. A charitable co-operative would also need to provide that all property of the co-operative will be distributed to qualified donees upon dissolution. These additional restrictions would reduce the flexibility in capital structure and activities that are attractive features of the co-operative form.
- **Reduced control for founding member.** Co-operatives are designed to be democratic. Thus, each member is given equal voting representation, regardless of the amount invested in the co-operative. This makes it difficult for a founding member to maintain control over the corporation.
- **Challenges in maintaining member participation.** Unlike other corporate forms, which can be structured so as to require only limited ongoing participation by the members of the corporation, co-operatives are designed with a view to having high levels of member participation. This can make the management of a co-operative more challenging than other corporate forms.

(e) Hybrid entities – a possibility in the future?

(i) CICs and L3Cs

As noted, Canada has not yet developed a specialized corporate form to accommodate the combination of for-profit and social purposes that characterize social enterprise. However, developments in other jurisdictions offer different models for the establishment of specialized corporate forms and legal regimes to govern social enterprises. The U.K. has introduced the Community Interest Company ("CIC")³⁹, while several U.S. states have introduced low profit limited liability companies ("L3C").⁴⁰

³⁹ CICs are provided for under Part 2 of the U.K. *Companies (Audit, Investigations and Community Enterprise) Act 2004*, (c. 27). A detailed Guidance on the rules surrounding CICs is available from the Regulator of Community Interest Companies, online at <http://www.bis.gov.uk/cicregulator/guidance>.

⁴⁰ The first limited liability company statute was passed in Vermont in 2008. Since then, several other states have introduced similar legislation.

“Some hybrid entities are designed to permit the use of a for-profit social pursuit and to facilitate public investment without relying on the traditional tax incentives for public donations.”

Both CICs and L3Cs have broad similarities. They are designed to permit the use of for-profit of a social purpose, as well as to facilitate public investment in the activities in pursuit enterprise without relying on the traditional tax incentives for public donations. The basic structure for both is the limited liability company. Unlike registered charities, CICs and L3Cs are not required to limit their permitted purposes to exclusively charitable purposes. CICs are required to meet a “community interest test” which evaluates the underlying purpose of a company’s activities and which seeks to determine whether a reasonable person would conclude that the activities of the CIC are directed towards a community benefit.⁴¹ L3Cs 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). Both are permitted to pursue profit, but this must be a secondary purpose.

The capital structure of CICs and L3Cs is considerably more flexible than for registered charities or NPOs. CICs are permitted have shareholders and pay dividends, but dividends are subject to a cap.⁴² This is designed to permit some limited return to attract investment, but also to ensure that a substantial portion of the CIC’s assets contribute to the social purpose rather than payments to shareholders. In this respect they have some similarity with co-operatives. L3Cs are permitted to have varying tranches of investors, with some tranches receiving below-market returns (designed for program-related investments by U.S. foundations) and others receiving market rates of returns.

The assets of a CIC are subject to an “asset-lock,” meaning that the assets of the CIC must either be used in furtherance of the social purposes or be transferred for fair market value consideration to another asset-locked organization, such as another CIC or asset-locked charity.

From this summary, the main potential advantages of a hybrid entity are clear:

- **Legally enforced social purpose.** Like charities and NPOs (and to a lesser degree co-operatives), CICs and L3Cs can hold themselves out as being bound to a social mission (if perhaps not as restrictive as for charities and NPOs). This may aid in the marketing of the organization and its activities.
- **Flexibility re: activities.** Like for-profits, CICs and L3Cs are relatively free to conduct activities and pursue new opportunities, provided that the social purpose is the ultimate goal of the activity. This affords greater flexibility than is available under the traditional non-profit structures.
- **Flexible capital structure.** CICs and L3Cs are capable of offering returns on investment to attract share capital that is not possible through the traditional charity and NPO structure.

The disadvantages of such hybrid entities include:

- **No preferential tax treatment.** CICs and L3Cs have not received favourable tax treatment in the U.K. or the U.S. Thus, they are not generally exempt from tax, and contributions to such entities do not receive favourable tax recognition. It has been suggested that without the introduction of such favourable tax status, the fundamental goal of such hybrid entities will be difficult to achieve.⁴³
- **Unfamiliarity of structure.** Unlike for-profit corporations, charities, NPOs and co-operatives – all of which are reasonably familiar to those involved in these sectors – hybrid forms are new and will take time to become familiar. Both the details of legal compliance as well as the practical realities of marketing and operating through a hybrid structure are not well-established. This creates difficulties in planning around these structures.
- **Difficulties in exiting.** To the extent that hybrid structures may be subject to an asset lock, many of the same difficulties that are associated with winding up a charity or converting it to another form would attend the wind-up of a hybrid corporation.

There are signs that some jurisdictions in Canada may follow the U.K. or U.S. 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-like regime in British Columbia, modelled after the U.K. regime. Other groups across Canada have made submissions to all levels of government seeking the

⁴¹ Applicants for CIC status must complete a Community Interest Statement on Form CIC 37, available at <http://www.bis.gov.uk/cicregulator/forms-introduction>.

⁴² An overview of the calculation of the dividend cap is provided at Chapter 6.3 of the Guidance for Community Interest Companies. The maximum dividend that can be paid on any given share is limited to 5% (for shares issued between July 1, 2005 and April 5, 2010) or 6% (for shares issued on or after April 6 2010) above the Bank of England base lending rate of the paid-up value of a share. Aggregate dividends are limited to 35% of distributable profits.

⁴³ See, for example, Daniel Kleinberger, “Fatal Design Defects of L3Cs,” Non-Profit Quarterly (Summer 2010).

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 a popular vehicle for social enterprise in the U.K. and the U.S., that many jurisdictions in Canada will follow suit.

(ii) B corporations

Another related development in the U.S. has been the introduction of 'benefit corporations', or B corporations.⁴⁴ B corporations are an innovation of B Lab, a non-profit organization based in Pennsylvania, whose stated purpose is to use the power of business to solve social and environmental problems.' The B Corporation is not generally a distinct corporate form,⁴⁵ but rather a designation given to an organization (which may take a variety of forms) that meets certain standards of socially conscious and responsible business practices. Organizations – including organizations in Canada – can apply to B Lab for certification as a B corporation, and must complete a 'B Impact Assessment', which reviews the organization's impact on all of its stakeholders, including its employees, its consumers, its community, and the environment. Applicants that pass this evaluation must, depending on their corporate form, then amend their constating documents to incorporate the consideration of community and stakeholder interests in corporate decision-making. Depending on the corporate form and jurisdiction of incorporation, B Lab provides recommended language to be incorporated into the governing documents, which must provide that directors and officers must consider the following interests when making corporate decisions:

The long-term prospects and interests of the Company and its members, and the social, economic, legal, or other effects of any action on the current and retired employees, the suppliers and customers of the Company or its subsidiaries, and the communities and society in which the Company or its subsidiaries operate (collectively, with the members, the "Stakeholders"), together with the short-term, as well as long-term, interests of its members and the effect of the Company's operations (and its subsidiaries' operations) on the environment and the economy of the state, the region and the nation.

Upon making any necessary amendments to the organization's governing documents, the organization can then be certified as a B corporation upon payment of a licensing fee. B corporations are subject to periodic audits by B Lab to confirm that the organization continues to meet the required standards of good practices.

B corporation certification is available only to for-profit corporations. The potential advantage of B corporation status relates to an organization's ability to hold itself out as achieving a social and community impact, as well as meeting high standards of transparency and corporate responsibility. This may aid in attracting capital from investors seeking to invest in organizations that meet such standards, as well as in differentiating the organization in the marketplace. Given that the flexibility of for-profit forms can be combined with a certification of social purpose, the B Corporation can be advantageous in allowing for flexible financing through a for-profit form, while overcoming the perceived lack of formal social purpose that can hinder efforts by for-profit organizations to hold themselves out as having a social mission.

⁴⁴ <http://www.bcorporation.net/about>.

⁴⁵ Although a few U.S. states have passed or introduced legislation to establish the benefit corporation as a distinct corporate form: for a list of these states, see <http://www.bcorporation.net/publicpolicy>. While the legislation varies from state to state, all essentially incorporate the B Lab requirements regarding corporate responsibility, community purpose, and transparency into the corporate structure of corporations incorporated under local B corporation legislation.

Conclusion

To summarize, there are four essential questions that every social entrepreneur must ask at the outset of a social venture:

- What is the fundamental purpose of the venture: to make money for myself/my investors, or to further a social purpose?
- How much control do I want to maintain and with whom am I willing to share control?
- How will the venture be positioned in the market?
- How will this venture be financed, both at start-up and on an ongoing basis?

It is clear from this summary that social entrepreneurs have a lot to consider before embarking on their venture. There are many options by which a social enterprise can be structured and many factors that will go into a decision as to which is best. Our hope is that this article has provided some insight into how these factors interact with the various structural options available (now and potentially in the future). With proper advice and sound planning, most if not all forms of social enterprise can be accommodated within the Canadian legal regime. As social enterprises play an increasingly prominent role alongside more traditionally operated for-profit and non-profit entities, we look forward to new innovations in how social enterprises are structured and carried out. The more options that are available to unlock funds and resources for the betterment of society, the better for everyone.