



Not-for-Profit Law

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Regulatory Rules and Social Enterprise

Federal and provincial governments are moving to stem spending in their efforts to return to balanced budgets. As usual, the charitable and non-profit sector seems to be a prime target of the effort to achieve savings. This is so despite the sector not benefiting proportionately from infrastructure and other government spending brought in to mitigate the recession after the meltdown in financial markets.

But, even though sector organizations didn't receive much of the stimulus spending, it seems that in the short and medium term they will face increased pressure to become more self-reliant and, failing that, to cut services. One avenue that is often seen as offering charities the opportunity to become more self-reliant is what is commonly called "social enterprise". To take full advantage of this opportunity, however, charities and non-profits would need to be given greater freedom to carry on in this type of activity. And part of the problem is that there is no common agreement on what social enterprise is all about.

While social enterprise revenues are no panacea for sector underfunding, the fiscal direction being taken by most governments in 2010 suggest that now is a good time to examine this issue.

A big part of the reason social enterprise has such a low profile in the charity and non-profit world is the restrictive treatment under Canadian law of what "enterprise" activities are available to charities and non-profits. Registered charities can only engage in businesses that are related to their mission or are predominantly volunteer run. This means, for instance, that a charity mandated to alleviate poverty can run a second-hand clothing store, but that it can't, as part of its operations, own a recycling plant and use the profits from the plant to fund its other work. Private foundations may not carry on businesses at all.

Moreover, two recent rulings from the Canada Revenue Agency suggest that non-profit organizations cannot intentionally generate surpluses and retain their *Income Tax Act* (ITA) non-profit status. If they earn revenues in excess of their costs, they are only entitled to have those revenues as tax-exempt if they earn them accidentally or serendipitously. That calls into question the ability of non-profit organizations to accumulate reserves for which they have no specified purpose.

If the rulings are correct, and non-profits can't accumulate reserves other than for purposes specified in their budget, it exacerbates the already significant problems many public benefit non-profit organizations have in raising capital. Currently these groups can't get funding from registered charities, because a charity cannot fund an entity that is not a qualified donee. Now, without the ability to accumulate unassigned reserves, they will also have less collateral to offer banks if they need an operating loan.

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While in the U.S. and U.K. corporate structures that allow for private investment in public benefit entities have recently been introduced, in Canada, the principal vehicle for charitable and non-profit undertakings remains the non-share corporation. Non-share corporations are generally an awkward vehicle for private investors.

There are a number of ways in which the rules might be loosened to promote social enterprise. These include allowing more freedom for registered charities to engage in social enterprises themselves, permitting registered charities to fund or invest in social enterprise, and extending the type of tax benefits received by donors to registered charities to supporters of social enterprise. A prerequisite to any of these approaches is the need for a better definition of what constitutes social enterprise – a significant matter of contention even amongst practitioners.

There are a number of ways to grapple with the definition of social enterprise. Choosing the right approach is likely key to successfully opening up this area.

One option is to pursue the issue through the courts. In many cases, social enterprise does not fit within the current definition of charity. That's because either the purpose of the undertaking is not analogous with elements of the definition previously found to be charitable by the courts or because the structure of the proposed social enterprise offends the limits on private benefit integral to the definition of charity. As the purposes considered charitable by the courts are notionally supposed to evolve over time in light of contemporary circumstances and values, and as the courts have never developed a quantitative test for permissible private benefit, there is opportunity for the courts to find significant amounts of what is now classed as social enterprise to also be considered charitable.

However, Canadian courts have not shown themselves to be enthusiastic about extending the definition of charity and in particular in widening it in a way that might have substantial fiscal impact.

Another route would be to seek legislative change and entrench a definition of social enterprise in the *Income Tax Act*. This could be done either through deeming certain purposes and/or activities to be akin to charitable purposes or through creating a statutory definition of charity that includes aspects of social enterprise. Under the *ITA*, Registered Canadian Amateur Athletics Associations and National Arts Service Organizations are already considered quasi-charities. In the U.K., they have moved to a statutory definition of charity that includes elements of social enterprise. Variations of this would be to amend the *ITA* to include an entirely new category of entities entitled to a certain preferential tax treatment, or to change the definition of related business to include certain defined social enterprise.

Again, in Canada, success in achieving legislative change around the definition has been limited and is likely nearly impossible without sector consensus around what types of undertakings should be considered social enterprise and what types wouldn't qualify.

Yet another option is to try to situate social enterprise within the existing regulatory framework with only minor legislative or administrative adjustments. This approach,

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for example, might entail collaboration or partnership between social enterprises and the category of groups identified under the *ITA* as qualified donees. Qualified donees include registered charities, but also certain other institutions or organizations, including municipal governments and certain provincial and federal Crown agencies. Registered charities can grant to qualified donees, even when they are not other registered charities, and any qualified donee can issue a tax receipt for contributions made to it by individuals or corporations. So this type of arrangement could help social enterprises solve the problems they now have with gaining access to capital.

As well, many municipal governments have offices or programs to promote community economic development or incubate small enterprise in their locality. Federal and provincial governments also frequently have initiatives in this area. By building on this infrastructure and expertise, increased support for social enterprise could be prudently funnelled through current qualified donees without major changes to existing rules.

This approach also has the advantage of seeing social enterprise defined at the community level instead of top down in legislation or by the courts.

What's needed to make it happen is for the federal government:

- to adopt as policy a position that this type of collaboration does not contravene the *ITA*;
- set out some minimum criteria for the kinds of organizations qualified donees should consider partnering or collaborating with;
- indicate a model for an acceptable corporate structure;
- define appropriate procedures for flowing funds to and from a charity affiliated with the social enterprise to ensure monies don't get diverted to the general revenues of the qualified donee; and
- consider designating the various provincial foundations that administer lottery monies as qualified donees and working with the provinces to expand the mandate of these groups, where necessary, to assist in fostering social enterprise. (This could benefit smaller communities where municipal government does not have community economic development expertise.)

These measures aren't a panacea, but they offer an opportunity that is low cost and can be implemented in short order. And they could mark a small step in increasing the sustainability of public benefit organizations.

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