



Social enterprise business structure: Some considerations for registered charities

'Social enterprise' has, as yet, no legal meaning in Canada. The Income Tax Act allows charitable organizations and public foundations to undertake *related* business activities, but not *unrelated* business activities, while private foundations cannot undertake any business activities.

CRA's policy statement CPS-019 'What is a Related Business?' gives guidance to registered charities on business activities (social enterprise)¹. This is a must-read for any charities considering undertaking social enterprise.

What is not a business activity (and therefore allowable)

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

Related business (i.e. allowable social enterprise activity within a charitable organization or public foundation)

The Canada Revenue Agency (CRA) defines 'related businesses' as two kinds: 1) businesses that are run substantially by volunteers²; or 2) businesses that are linked to a charity's purpose and subordinate to that purpose.

To expand on the second definition, 'linkage' cannot be claimed merely by the fact that the profits from a business are directed to a charity³. 'Linkage' to the

¹ It can be accessed in its entirety at www.cra-arc.gc.ca/tx/chrts/plcy/cps/cps-019-eng.html

² This means that at least 90% of the staff of the social enterprise must be volunteers (calculated by head count, not hours).

³ Ibid., section 20. This is called the 'destination test', and in the UK, holds as a legitimate means of proving linkage (and therefore income tax exemption).

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. hospital parking lot)
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)
4. Involve the sale of items that promote the charity and its objects (e.g. calendars, T-shirts, etc.).

'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.

Unrelated business (i.e. prohibited social enterprise activity within a charitable organization or public foundation) / separate legal entities

If the enterprise is not substantially run by volunteers and it is unable to establish linkage and subordination as outlined above, then it is considered to be an unrelated business by CRA.

As charitable organizations and public foundations are only permitted to run related businesses; they do not have the option of operating unrelated businesses as a project of the organization.

A separate entity must run the unrelated business.

Usually, a taxable corporation⁴ is established, which must operate at absolute arms' length from the charity.

The corporate entity cannot benefit from the charity. Many charities enact absolute separation of staff, equipment, location, and sundry supplies (or a clear paper trail that shows the corporation paying fair market value for use of the charity's resources).

⁴ Ibid., sections 47 and 48.

The unrelated business within the corporate structure remits corporate taxes on net income derived from social enterprise activity. Corporations are allowed to donate up to 75% of net profits to any charity, paying income tax on the remaining net profit after the donation is made.

Charitable receipting and unrelated business

An unrelated business cannot issue a charitable receipt for donations directed explicitly to the social enterprise because the entity does not have charitable status. If the social enterprise were a related business, the parent charity could issue a charitable receipt for the donation.

Benefits of running a related business

If the social enterprise is a related business, it can operate as a project within the charity, until such time that it demonstrates success and maturity, warranting the move to separately incorporate. In fact, most related social enterprise businesses operating in Canada remain as projects, but the benefits of incorporating at a time of maturity include legal protection of the parent organization from the activities of the social enterprise, greater ability to attract financing, and the possibility of taking on other business partners.

In the short term, as the charity builds the (related) business, management of the social enterprise could be integrated with the main organization, resources could be shared, and there would be no extra costs for incorporation and annual filings of corporate tax returns (T2's). In addition, net profits of the project would not be taxable, enabling a greater net profit amount to flow towards supporting parent charity programs and administrative costs. This can only occur if the social enterprise is deemed to be a related business.

To summarize

There are clearly benefits and detriments to both scenarios (unrelated and related business).

Related business benefits

- Able to issue official charitable tax receipts for donations benefiting the social enterprise
- Ease of governance (only one Board)
- Increased efficiencies in costs (through sharing resources)
- Increased positive community support (not as likely to be viewed as 'competing' with business)

- Net profit is not taxed, leaving a greater amount to direct to charitable programs
- Potential to access program funds and grants for some social enterprises
- Simplicity / low cost of business formation
- Social enterprise purpose in line with charitable purpose (lower risk of mission drift / competition of priorities)

Related business drawbacks

- Inability to attract traditional business investment
- No potential for expansion of ownership table
- No legal protection of charity from activities of business

Unrelated business benefits

- Increased ability to attract outside investment through enhanced financing opportunities
- Potential for expansion of ownership table to include the private sector
- Protection of charity from more risky business activities
- Unequivocal protection of charity from threat of charity status revocation

Unrelated business drawbacks

- Additional costs of incorporation and annual tax filings
- Complexity in establishing separate governance structure (separate Board)
- Net profit is taxed (after donations)
- Potential lack of efficiencies in terms of inability to share resources of parent charity
- More likely to be viewed by traditional business sector as 'unfair competition'

Social businesses and training businesses

The 1999 guidance paper RC4143(E) from CRA entitled 'Community Economic Development Programs'⁵ 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, and enjoy all of the benefits of related business as outlined above.

⁵ This document can be viewed in its entirety at www.cra-arc.gc.ca/E/pub/tg/rc4143/rc4143-e.html.

From CRA's perspective, training businesses and social businesses are not considered as 'businesses' at all – rather, they are acceptable charitable activities (assuming that the activities relate to the charitable purposes of the specific charity).

It is important to note that a profit motive cannot enter into either of these expressions of social enterprise. CRA's definitions of training businesses and social businesses bear quoting in full:

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.

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.

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