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Social Enterprise Legal Structure: Options and Prospects for a ‘Made in Canada’ Solution

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Executive Summary

The purpose of this project was to canvass social entrepreneurs and social economy “experts” with respect to the prospects and potential drawbacks associated with pursuing a separate legal structure for social enterprise in Canada. The project emerged from a variety of drivers associated with the advancement and relative maturation of the Canadian social enterprise sector, including coordination and mobilization within the sector, a variety of recent research initiatives seeking to better understand the social economy, and government interest in seeking – or accommodating – ways to stimulate private capital for public good. We hope that our findings contribute to the discourse on social enterprise sustainability and add value to much needed efforts to educate and inform both the sector and policy actors on issues of social enterprise structure.

The methodology for the project consisted of four main phases: 1) a literature review; 2) key informant interviews with social enterprise and legal experts; 3) questionnaire design and peer review; and 4) questionnaire implementation. Our final sample was 20 social enterprise representatives (not including key informants), from across Canada, whom we engaged in a questionnaire interview that enabled us to maintain question consistency, but also provided the option of a more general discussion about the issues (i.e. semi-structured).

In order to better understand the issues associated with legal structure in different contexts, the literature review covered a broad continuum between revenue-generating projects operated by charities and non-profits, to businesses engaged in multiple-bottom line ventures. Our focus for the survey was on community-based social enterprises, in order to assess the knowledge base and preferences of social enterprise operators. Many of these groups operate using the legal structures of charities, non-profit organizations, and co-operatives. We note the potential limits of these structures for social enterprise operation within this paper.

If expanded efforts of consultation and education result in informed, broad sectoral support for change, the new structure should maximize benefits while being made up of as few components as possible to enable progressive adaptation. To be most effective, such changes should also be accompanied by supportive infrastructure and promotion, without diminishing the value of social enterprises not choosing the new structure.

Characteristics of a new legal form for social enterprise might include some combination of the following attributes:

- Ability to sell investment shares
- Ability to host hybrid ownership (e.g. a social enterprise jointly owned by a charity and a private business)
- Ability to brand the social enterprise sector
- Status as a qualified donee – qualifies for grants from charitable organizations
- Caps (limits) on dividends and interest paid out
- Asset lock – upon dissolution, can only divest assets to another

- Ability to remunerate Directors, e.g. now, founders of non-profits and charities need to choose between control (e.g. serving on the Board) and remuneration (e.g. serving as staff)
- Ease of the social enterprise sector to track outcomes.
- Ability of the government to stimulate the social enterprise sector through income tax reductions, and other incentives
- Qualifies for investment tax credits
- Ease of use for program-related investing by foundations
- asset-locked body such as a charity or the new structure
- Light-touch regulation / ease of formation
- Wide definition of community-interest (e.g. as opposed to the four heads of charity)
- Reduced income tax rates or tax exemption
- Pass-through entity (each owner pays income tax based on their own legal situation)

We encountered a significant amount of research fatigue in canvassing social entrepreneurs across the country. This is likely due to the number and duration of recent research initiatives associated with inquiry into the social economy. The implementation of the research design also yielded perhaps our most significant finding: social entrepreneurs are not generally well-informed about the dynamics of social enterprise legal structure. This includes knowledge of their own structure (and the rationale for having chosen it), and knowledge of other structures and possibilities / limitations associated with potential reforms. This presented a challenge in terms of identifying respondents who were able to respond to our invitations to participate in the project.

Despite the complexity of the issue and challenge to form an informed sample, our key informants and core sample of social entrepreneurs were able to clearly articulate a variety of issues associated with the pros and cons of creating a separate social enterprise legal structure in Canada. Table 1 summarizes these findings, providing a quick reference of main points that we elaborate upon in the full report, organized into five main content themes. These issues help to inform practitioners and policy-makers of the divergent views and concerns within the sector and will help to organize and target interventions aimed at capacity building and education.

Our recommendations highlight the need for further consultation and education within the sector before proceeding with regulatory reform. This will help to ensure that the positive effects and potential associated with regulatory change overshadow and address any unintended negative consequences at both organizational and systemic levels.

Table 1. Summary of Pros and Cons Associated with a Separate Social Enterprise Legal Structure

Pro	Research Theme	Con
<ul style="list-style-type: none"> Clarified legal structure will bring certainty to the sector. Clear definition will help to coordinate efforts surrounding presenting a specific brand identity to communities and investors. 	<p style="text-align: center;">Definition</p>	<ul style="list-style-type: none"> A concrete definition of social enterprise may have unintended consequences. Concern that government will not “get it right”.
<ul style="list-style-type: none"> Legal structure will help to create a common language for social enterprise. Opportunity to learn from examples in other countries and adapt to the Canadian context. Legal structure will go through a period of adaptation. The sector and regulators can monitor the situation and seek to address any unintended consequences through regulatory amendments. 	<p style="text-align: center;">Innovation</p>	<ul style="list-style-type: none"> Imposing a legal structure on social enterprises could inhibit or prevent possible future innovations. “If it’s not broken, don’t fix it”.
<ul style="list-style-type: none"> Ability to access new sources of capital. Diminished granting environment expected in future. 	<p style="text-align: center;">Finance</p>	<ul style="list-style-type: none"> Loss of access to grants through conversion to new structure. Jurisdictional confusion re: taxes and tax rates. Reform rather than regulate.
<ul style="list-style-type: none"> Simply one more vehicle (or choice) that is available to a dynamic sector – not “either / or”. Recognize general trend of decline in government funding – need for new investment vehicles. 	<p style="text-align: center;">Government</p>	<ul style="list-style-type: none"> Legal reform could be used as an excuse for cutting funding – off-loading – to the social enterprise sector.
<ul style="list-style-type: none"> Concern that current innovations in the system may be operating “off-side” of CRA rules. Legal reform would clarify this uncertainty. 	<p style="text-align: center;">System Abuse</p>	<ul style="list-style-type: none"> Risk that the new legal entities could be abused by for-profit companies. New legal status may expose social enterprises to the vagaries of private investors. Any abuses to the system via the new business models may unduly tarnish an emergent sector.

1 Introduction

The purpose of this project was to canvass social entrepreneurs and social economy “experts” with respect to the prospects and potential drawbacks associated with pursuing a separate legal structure for social enterprise in Canada. The project emerged from a variety of drivers associated with the advancement and maturation of the Canadian social enterprise sector, including coordination and mobilization within the sector, a flurry of recent research initiatives seeking to better understand the social economy, and government interest in seeking – or accommodating – ways to stimulate private capital for public good (Canadian Task Force on Social Finance, 2010). There is also the opinion within certain circles that the social enterprise sector has reached a sort of “tipping-point” in terms of its scale and sophistication, requiring new and more clearly defined ways to support organizational viability and sustainability.

Another significant motivation for this project, which was certainly verified through the research, is the general state of confusion surrounding social enterprise legal structure. Mulholland et al. (2011) emphasize the fragmentation among provincial and federal levels of government, and the lack of a mechanism to introduce relevant and useful changes to the systems governing the social enterprise sector:

Ideally, policy and regulatory frameworks governing the sector would enable innovation and entrepreneurship, especially with respect to opening up new sources of earned revenue. Currently, however, charities and non-profits struggle with a confusing and onerous patchwork of different provincial rules and regulations across the country. They also face increasingly restrictive federal regulatory constraints on their ability to generate new sources of revenue through social enterprise (p2).

Based on interviews with government representatives and non-profit leaders across the nation, Muholland et al. suggest that the organizational sustainability of the community-based sector should be a stated priority of governments, and that conscious intent should be directed to sorting through the current inter-jurisdictional patchwork, modernizing laws and regulations where necessary.

At the time that we proposed the research, there also existed a high level of concern and confusion surrounding recent Canadian Revenue Agency (CRA) rulings regarding whether existing social enterprises are operating within or “offside” of the current legal requirements for charities and non-profit organizations. This uncertainty is reflective of a sector that has grown and evolved quickly to meet community needs in innovative ways that may have out-paced commonly used structures (Carter and Man, 2008). The innovative pace on the ground has also surpassed a cohesive and coherent understanding within the sector about the status and structure of organizations operating within the social economy.

In the following sections, we provide a literature review on social enterprise and seek to outline a framework of different organizational structures and norms within the social economy sector. We then review the methodology for the project, and present our key findings. Finally, we conclude with a set of recommendations and identify areas for further research.

It is our hope that this report contributes to the discourse about the social economy that is being supported by many recent and comprehensive research initiatives. We have endeavored to keep up with the fast pace of change and dynamism that exists at the community and neighbourhood level within Canada's social enterprise sector. However, we fully realize – and celebrate! – that this is a tall order when researching such an innovative and responsive area.

2 Literature Review: Understanding the Social Economy

2.1 Defining social enterprise

In February of 2004, the term 'social economy' was officially recognized in Canada in the Speech from the Throne as "the myriad not-for-profit activities and enterprises that harness civic and entrepreneurial energies for community benefit right across Canada" (Governor General Adrienne Clarkson, 2004). An extremely broad and complex expression, the social economy is often thought of merely in terms of being outside either the for-profit or private sector, and the public or governmental sector, functioning as the "third sector" (Kay, 2005; Restakis, 2006). This third sector encompasses numerous stakeholders, including associations, charities, foundations, trusts, mutuals, non-profits, and co-ops. Defourny & Develtere (1999; p. 3) succinctly capture the potential vastness of the term, summing up the social economy as "any economic phenomenon that has a social dimension, and any social phenomenon that has an economic dimension". However, Lloyd (2007, p. 68) writes that within this third sector, only the "bodies that have an ambition to create a different sort of economy – one that has a different approach to the organisation of work and production and the distribution of surplus – constitute the formally defined social economy."

According to Lukkarinen (2005) organizations and companies within the social economy are people-centred and needs-based, and have significant job-generating potential, particularly for those who are disadvantaged by the traditional labour market. Social economy businesses performing these functions are often labeled "social purpose" enterprises. Social economy organizations (SEOs) may also be able to effectively meet local needs that have not been met by the market or existing government programs (Lukkarinen, 2005). The critical element of SEOs is that they are intended to serve a social or environmental purpose, which is the primary reason for their existence. SEOs tend to be closely linked to the community in which they operate, and often rely on volunteer labour and/or donations to function (Teitelbaum & Reimer, 2002). SEOs either have no shares at all or they charge membership fees, as in the case of co-operatives (Quarter, 1992). Defourny & Develtere (2004) emphasize that the surplus generated by an SEO is used as a means to provide a particular service and is not the main motivation behind that SEO's economic activities.

In contrast to social purpose enterprises, there exists a sub-category within the broader social economy which is referred to as 'social enterprise'. The term social enterprise is a relatively new one, having emerged in the last fifteen years (Defourny & Nyssens, 2006). Because of its recent emergence, there is still much discussion with respect to how to define it. A thorough exploration of this debate by Defourny and Nyssens (2006) reveals that there is significant variance in the meaning of the term, depending on the geographic context in which it is being used. For example in the United States, the term social enterprise is rather vague, referring to "market-oriented economic activities serving a social goal" (Defourny & Nyssens, 2006, p. 4). The definition therefore encompasses a wide range of organizations, including both for-profit businesses that are engaged in socially beneficial activities, and not-for-profit organizations that provide a mission-supporting commercial activity (Defourny & Nyssens, 2006).

The BALTA (BC Alberta Social Economy Alliance) definition of the social economy includes those organizations that are animated by the principle of reciprocity for the pursuit of mutual economic or social goals, often through social control of capital. This definition would include all co-operatives and credit unions, non-profit and volunteer organisations, charities and foundations, service associations, community enterprises, and social enterprises *that use market mechanisms to pursue explicit social objectives*. It would also include for-profit businesses, where those businesses share surpluses and benefits with members (and/or the wider community) in a collectively owned structure (e.g. a co-operative). This would not include those non-profit and voluntary organizations that are entirely grant or donation dependent.

The exact size of the social enterprise sector is unknown (in part because they operate under every legal structure currently available in Canada, resulting in tracking challenges), but there is ample evidence to suggest that this sector represents a significant and rapidly expanding part of Canada's socio-economic infrastructure (Neamtan & Downing, 2005). If one includes gross revenues for businesses operated by not-for-profits, co-operatives, and mission-driven for-profits, this sector is a significant economic player.

Excluding hospitals, universities, and colleges, the voluntary sector earns 43% of its revenue from the sale of products, memberships, and fee-for-service activities. It generates an additional 36% from grants and contributions, while only 11% comes from individual donors (Brodhead, 2010).

Of the 196 non-profit organizations surveyed in the Ontario-based Social Finance Census (Malhotra et al., 2010), we know that:

- 46% of non-profits are now engaged in social enterprise activity
- 1/3 of those remaining plan to enter the field in the next 2 years
- 25% of the social enterprises now existing contribute to more than 50% of the parent's operations
- 1 in 5 social enterprises have been operating for over 25 years

- 1 in 3 social enterprises has launched within the past 2 years

It has been estimated that the annual economic impact of social enterprise in the Canadian non-profit sector totals \$3.6B.

A recent study by Elson and Hall (2010) outlines the scale of social enterprise in BC and Alberta. They define social enterprise as:

...a business venture, owned or operated by a non-profit organization that sells goods or provides services in the market for the purpose of creating a blended return on investment: financial, social, environmental, and cultural (p10).

Key indicators drawn from the report, assessing 295 confirmed social enterprises (231 in BC and 64 in Alberta) indicate that the sector employed 4,500 people and conducted \$78M in annual gross sales. The purposes of the enterprises were as follows: mission-based – 43.4%; employment development – 32.1%; and income generation for parent organization – 24.5%. Important for this study, the research done by Elson and Hall indicates the following breakdown of legal structure in the two provinces (multiple responses, as for example, most charities are also non-profits; and co-ops can be for-profit or non-profit):

- Registered charity – 55.6%
- Not-for-profit – 61.1%
- Co-operative – 14.8%
- For-profit – 20.4%

Ultimately, as Mendell (2010) states, it is difficult to address social enterprise from a Canadian perspective because of the regional diversity within the country, and its variegated political and economic landscape. For our purposes (and to identify and clarify our objectives to research respondents), we defined social enterprise as:

...selling a good or a service to the marketplace for the purpose(s) of:

- Generating revenue for a community-based organization, thereby enabling it to undertake more of its mission-related work; and/or
- Creating employment or training opportunities for the marginalized; and/or
- Creating a social, environmental, or cultural value; and/or
- Meeting a community need that the traditional marketplace does not.

In the following sections, we begin with a section outlining the role of the law. We then move on to identify different components of the social economy sector and seek to clarify some of the confusion surrounding structural differences between different models and their legal ramifications.

2.2 The law

The role that law plays in the social economy depends on intent and context. When faced with a proposal for a change to the law or the creation of a new law, two questions should be asked: What outcomes are intended by this law? And, what is the context in which those outcomes will be created?

With regard to the creation of a new social enterprise legal structure, stated intentions include supporting innovation, providing clarity to words or definitions, facilitating the formation of specific types of social economy organizations, increasing the ability of government to collect data, and increasing the ability of social economy businesses to raise private funds. The context, in this case, depends on which part of the social economy is being discussed, including charities, not-for-profits, co-ops, social purpose businesses, social economy businesses, or social entrepreneurship.

In each of these contexts, the law can be used with any or all of the intentions listed above. However, how the law is structured in each context to fulfill the specific intention will be different. For example, to support innovation in a newly formed organizational type or emerging market, sometimes it is best not to have laws because laws provide structure and standardization, somewhat limiting future possibilities, often slowing down or stopping innovation. For example, corporations and co-operatives were not legal creations. They were practices that evolved out of the activities of groups that were naturally forming in response to social and business needs. The law stepped in after the fact to 'formalize' these structures (corporations in 1855 and co-operatives in the 1920s), and those structures have not changed much since. Armand Dubois (1938) has provided an amazingly detailed account of how this process worked in the period before the first Corporations Act in the U.K. in 1855, while the history of the development of the co-operative movement has been chronicled in many places (Cobia, 1989). This non-interventionist legal approach was also followed in China when the Chinese government introduced corporations, the stock exchange, and other market institutions into the socialist economy. It did not pass laws. Instead, it allowed regional experimentation authorizing each province to create its own corporations and stock exchanges. National corporation and securities laws were passed only after 10 years of experimentation based on the best innovations found in each of the Provinces (Clarke, 1991).

In contrast, in more mature organizational forms or markets, the law can be a positive force supporting innovation, by changing the rules and destabilizing the context by creating external pressures for innovation. For example, the Japanese Government recently imported the U.S. take-over bid rules to try to disrupt the mature, stable, and slow growing Japanese economy to shift to a high growth trajectory (Cody, 2010).

The law as a tool for creating an intention always carries with it the danger of unintended consequences. This is because human social systems, markets, and organizations are complex spaces full of interdependent relationships that cannot easily be directed towards desired end states. History is full of examples in which good intentioned laws created an effect opposite to their stated intent. For example, sociologist Neil Fligstein has argued that U.S. Anti-Trusts that were intended to break up the monopolistic power

of the oil and railroad trusts created the large multinational corporation (Fligstein, 1990); and the disastrous outcomes of the imposition of U.S. laws and legal institutions in Russia after the fall of the Soviet Union have been well documented (Black et al., 2000).

To reduce the likelihood of unintended consequences, it is useful to keep two things in mind: 1) use the law only in situations where the intent is clear, the context is known, and there is a logical match between the two, and 2) always use the least interventionist legal approach possible (in terms of both volume of law and the amount of control exerted over the context) (Ayres and Braithwaite 1991).

Furthermore, the creation of laws that affect complicated social processes and systems like the economy need to be the result of collaboration: co-constructed amongst all participants in that system (Bryant, 2010). In the case of social economy reform, it would include, at a minimum, collaboration amongst social economy businesses, entities that fund the social economy, consumers, and the government. This is because the desired legal outcomes can often only be accomplished by a whole system approach that combines social, political, and legal reforms and activities (Clarke, 1991). This requires each of the parties to contribute their knowledge and views on the complex situation to the overall solution.

There is already a large amount of law affecting the social economy in Canada. Most of it takes the form of tax laws and regulations (including the charities portion of the federal *Income Tax Act*) and the laws related to the different legal structures already available in Canada: not-for-profits, co-ops, corporations etc.

It is noteworthy that Canada operates under a permissible legal structure, meaning that unless an activity is explicitly named as offside, the activity is considered legal. CRA guidance papers and rulings explicitly outline what is not permitted for social enterprises using charitable organizations and non-profits. These nuances are detailed below.

2.3 Charities versus non-profits

All charities are not-for-profits. Not all not-for-profits are charities. An organization must first establish itself as a not-for-profit before it applies to the Canada Revenue Agency's (CRA's) Charities Directorate to apply for charitable status.

Many organizations remain as not-for-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'.

Not all organizations can become charities, even if they wish to make application. The activities of the charity must fall under at least one of these four 'heads' of charity:

- Relief of poverty
- Advancement of education
- Advancement of religion
- Other purposes beneficial to the community not falling under the first three categories [must be demonstrated to be for public benefit, and supported by case law]

There are roughly 85,000 charities in Canada, and (it is estimated) at least as many not-for-profits without charitable status. Neither organization can sell investment shares in order to raise capital.

2.4 Charities and social enterprise

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 Canadian charities considering or engaged in social enterprise.

'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 operating an unrelated business. The differences between the two are clarified below.

The CRA does not consider as business (i.e. social enterprise): soliciting donations, selling donated goods (without modifying them)⁵, 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 CRA defines 'related businesses' as two kinds: 1) businesses that are run substantially by volunteers⁶; 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 further tests for linkage and subordination need not be applied.

⁵ Clarification is expected to be released by the Charities Directorate in coming months explaining that the intent of the 'selling donated goods' rule is not for storefront operations such as thrift stores. It is intended for 'one off' situations, such as a church receiving a donated art piece, then selling the art in order to obtain cash to direct to charitable activities.

⁶ This means that at least 90% of the staff of the social enterprise must be volunteers (calculated by head count, not hours).

Most social enterprises do not have the luxury of a workforce that is made up of 90% volunteers, so the second part of the CRA definition of related business must be explored. 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 (very specific) tests. It must:

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 church parking lot use during hours of closure, or renting out event tents when not being used by an arts-related 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.

Many organizations define 'linkage' 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 volunteers do not substantially run the social enterprise, or 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 corporation), 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 from the charity that owns it (including accessing grants and donations secured by the charity). Charities should enact absolute separation of staff, equipment, and sundry supplies (or, at minimum, a clear paper trail that shows the enterprise 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 flowing from social enterprise activity. The corporation is allowed to 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.

2.5 Social businesses and training businesses – operated by charities

The 1999 guidance paper RC4143(E) from CRA entitled 'Community Economic Development Programs' 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:

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.

2.6 Non-profits as ‘containers’ for social enterprise

It is generally believed that the not-for-profit structure is a ‘safer’ haven for social enterprise operation in Canada, since there seem to be such tight limits on charities operating social enterprises.

It is noteworthy that although non-profit organizations are usually formed under provincial acts and regulated by these bodies, the income tax exemption of non-profit organizations is conferred through the federal *Income Tax Act*. As such, issues of tax compliance of social enterprises operated within provincially incorporated non-profit organizations fall to the Canada Revenue Agency.

A recent CRA ruling has clarified assumptions about the relative safety of the not-for-profit organization as a safer structure for social enterprise. The November 2009 ruling was in response to questions that included these:

- Can a 149(1)(l) organization [i.e. a not-for-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)(l) exemption from tax?

The CRA response to the first question is yes... *but only by mistake*. The example given is if the not-for-profit over budgets its expenses, and turns a surplus as a 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)(l) entity.’

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

‘Profit’ is not defined as the organization’s ‘bottom line’ on their year-end income statement. Rather, each enterprising activity will be assessed as a discrete profit-generating activity, regardless of whether or not the surplus is directed to other activities within the same organization during the same fiscal year.

Further, the ruling states unequivocally that not-for-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.’ Contracts with ‘admin fees’ that contain profit margins would be an example of what is not allowed within the not-for-profit structure, without the organization losing its tax exemption.

Considering that many social enterprises are embedded within a not-for-profit structure, and earn profits to feed other aspects of the organization, we can imagine how many organizations are facing a structural barrier that they simply have no awareness of. The

CRA estimates that 75% of not-for-profit organizations are offside, based on a major audit project of the sector, which they completed in 2010. We expect CRA to issue educational materials in the coming months. At least five recent CRA rulings have supported the position, with a few pieces of case law (BBM Canada, Tourbec Inc.) also doing so.

The two most common expressions of being ‘offside with CRA’ are:

1. charities or public foundations⁷ operating an unrelated business (as defined by CRA) within the charity structure itself, and
2. not-for-profit organizations intentionally generating margins to feed their programs without paying corporate income tax on year-end net profits.

If the CRA becomes aware of a charity or public foundation running an unrelated business (i.e. without separately incorporating into a taxable entity), they would first assess a 5% penalty based on the gross sales of the social enterprise. The second infraction would involve a 100% penalty calculated on the gross sales of the social enterprise, plus a one-year suspension of tax receipting privileges. A third infraction would likely result in permanent revocation of the organization’s charitable status and the requirement that all assets be transferred to another charity.

If a not-for-profit organization generates profits (or even intends to do so), it remains as a not-for-profit within its provincial Act, but ceases to be a 149(1)(l) entity, meaning that it must remit corporate taxes on any year-end net profits. If the organization is found to be ‘acting’ as a 149(1)(l) entity (that is, not remitting corporate income tax), it will be assessed tax retroactively, and may further be penalized for lack of voluntary tax remittance. It is important to note that this is not a new position on the part of CRA. They observe that the issue seems to be of concern for the sector every decade or so, but that the CRA’s position has remained constant.

2.7 What does an ‘unrelated business’ look like?

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;*

⁷ Private foundations are not allowed to undertake any social enterprise activity.

- separate membership or shareholders; and
- separate equipment, personnel, and space⁸.

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.

2.8 Co-operatives⁹

Co-ops are vitally important to Canada's economy and communities. There are over 9,000 co-operatives serving over millions of members in virtually every field of endeavour.¹⁰ The Canadian Co-operative Association summarizes the key differences between business corporations and co-operatives this way:

Co-operatives are guided by these key principles:

- Voluntary and open membership;
- Democratic member control;
- Member economic participation;
- Autonomy and independence;
- Education, training, and information;
- Co-operation among co-operatives; and
- Concern for community.

Co-operatives can be viewed as well-established hybrids that successfully combine commercial and community mechanisms and interests. Co-operatives can be created for a wide range of purposes and activities – from purely commercial to charitable. While primarily driven to achieve member benefit, co-operatives can make community benefit their first priority, or they can combine member and community benefit as they choose. Co-operatives can also raise capital for community projects by issuing shares to members or outside investors. They can also maintain that upon dissolution or wind up, remaining assets must be transferred to a charity or other community organization.

The co-operative structure is an excellent organizational form for a wide range of enterprises and situations. Perhaps its greatest strengths are: a) economic democracy – one member one vote, not one share one vote; and b) the potential to counter Canada's seemingly endless incremental loss of ownership of commercial and industrial assets to non-Canadian corporate interests. Co-operatives provide a legal structure ideal for communities wishing to regain control of local economies and achieve economic self-determination. Examples are the purchase of a sawmill or manufacturing facility closed by a distant corporate head office.

⁸ If the equipment, personnel, or space are being shared, but the business is paying for their use, this is allowable.

⁹ Adapted from 'More Reflections on Legal Structure for Community Enterprise' by charity lawyer Richard Bridge, April 2010. www.centreforsocialenterprise.com/f/More_Reflections_on_Legal_Structure_for_Community_Enterprise_April_2010.pdf

¹⁰ Canadian Co-operative Association www.coopscanada.coop/en/about_co-operative/Co-op-Facts-and-Figures

But co-operatives are not appropriate for every situation. Co-operatives require a critical mass of members, who may be producers, workers, retailers, service providers, consumers, investors, or a combination of these (i.e. a multi-stakeholder co-operative). That critical mass of membership may be large, as with a retail co-operative or a credit union. Or it may be relatively small – for example, a handful of health care professionals who form a co-operative to deliver home care to seniors.

Within this critical mass of members, there must be a core group of committed and able members willing to do the hard work needed to make the co-operative enterprise work. In situations in which there is a critical mass of members and a core of committed and able members, a co-operative structure can be an excellent choice. But without that critical mass and core, a co-operative structure is not an option.

Most co-operatives file annual corporate information returns, remitting income tax at corporate tax rates. Some may qualify for the not-for-profit exemption (section 149(1)(l) of the *Income Tax Act*), community service co-operatives being one example (but they must be devoid of intentional profit on all activities).

2.9 Business corporations¹¹

Social enterprises can adopt the legal form of business corporations established under existing incorporation legislation. Indeed, this is the structure recommended by the CRA for registered charities that have engaged in or are considering an ‘unrelated’ business activity (see earlier section).

The essential objective recognized by corporate law and theory is the maximization of shareholder value. It is possible for business corporations to adopt other objectives, such as community or environmental benefit, and for corporate shareholders to enshrine these objectives or values in formal incorporation documents.

The BC government is currently undertaking research into the feasibility of enabling a new social enterprise option by embedding special enabling features within the BC *Business Corporations Act* that could be adopted by social enterprises to enshrine certain characteristics (e.g. stakeholder primacy, interest / dividend caps, an asset lock) within the existing corporate structure¹².

3 Methodology

The methodology for the project consisted of four main phases:

1. Literature Review:

We conducted a background literature review of social enterprise in Canada, and internationally. Our focus was on organizational structure and, where possible, legal and regulatory issues.

¹¹ Adapted from ‘More Reflections on Legal Structure for Community Enterprise’ by charity lawyer Richard Bridge, April 2010. www.centreforsocialenterprise.com/f/More_Reflections_on_Legal_Structure_for_Community_Enterprise_April_2010.pdf

¹² See <http://www.fin.gov.bc.ca/prs/cicc/>

There have been a number of recent research initiatives related to social enterprise sustainability and regulatory change (see: Canadian Task Force on Social Finance, 2010; Carter and Man, 2008; Eakin and Graham, 2009; Mulholland et al., 2010). For example, Recommendation #5 of the Canadian Task for on Social Finance (2010) calls for the following:

To ensure charities and non-profits are positioned to undertake revenue generating activities in support of their missions, regulators and policy makers need to modernize their frameworks. Policy makers should also explore the need for new hybrid corporate forms for social enterprises (p3).

All of these recent research initiatives provided invaluable information for our project, and helped to frame the issues within a relevant Canadian context.

In addition to searches in both academic and grey literatures, we also explored the dynamics of Community Interest Companies (CICs) in the UK; and Low Profit Limited Liability Companies (L3Cs) and Benefit Corporations in the US. These initiatives, while grounded in completely different historical and regulatory frameworks, provided useful comparative platforms from which to identify possible characteristics and implications associated with regulatory change in Canada. We have included findings from this material in Appendix A below.

2. Key Informant Interviews

Given the complexity and relatively emergent status of the Canadian discussion on regulatory change for social enterprise, we conducted seven interviews with “thought leaders” in the social enterprise sector. We identified these individuals through a combination of personal knowledge of the sector, individuals who have published material on social enterprise regulatory status, and suggestions drawn from these individuals with respect to additional key people to interview.

The key informant interviews provided a very important source of data for the project. Given the complexities of legal and regulatory change, drawing upon the experiential knowledge of this group helped us to frame the issues and identify critical questions to address in our broader research with social enterprise operators. We also sought key informants who would provide a balance between being in favour of and against legal regulatory reform for social enterprises in Canada.

3. Questionnaire Design

Using the information drawn from the literature review and key informant interviews, we designed a questionnaire for social enterprise operators. The questions were designed to a) identify the structure of their operation; b) assess any current advantages or challenges associated with the chosen legal structure; c) assess their support for or resistance to the idea of creating a separate legal structure for social enterprise in

Canada; and d) identify any general ideas for improving the status of social enterprises in Canada.

The questionnaire underwent many iterations, and was eventually peer reviewed by two colleagues to garner an external perspective and additional expertise on survey design and delivery.

4. Sample and Delivery

Although the literature review covers the broad continuum between revenue-generating projects operated by charities and non-profits, all the way to businesses engaged in multiple-bottom line ventures, our focus for the purpose of the survey was on community-based social enterprise. Many of these groups operate using the legal structures of charities, non-profit organizations, and co-operatives.

Our original respondent sample was drawn from a compiled list of social enterprises from across Canada. The emergent nature of the sector revealed itself very plainly in this search process, as comprehensive lists of social enterprises are largely non-existent; and if they do exist, they are not freely shared (for good reasons, e.g. privacy and ethical commitments of other research initiatives). This presented a significant challenge in terms of preparing a random sample. Organizations were identified through social enterprise umbrella organization and hub websites. As such, the “sample” is random to an extent (in terms of identification), however, does not provide any significance in terms of organizational type and structure of the respondents.

The most significant findings of our initial test questionnaires – and perhaps the most significant findings of the project – are that:

1. Social enterprises in Canada expressed a high level of research fatigue; and
2. Social enterprise operators are not generally well-informed about the dynamics of social enterprise legal structure. This includes knowledge of their own structure (and the rationale for having chosen it), and knowledge of other structures and possibilities / limitations associated with potential reforms.

In essence, we were asking questions to respondents who knew very little about the issue that we were researching, and who were tired of responding to research requests (a comment both on the size and scale of the social enterprise sector, and the numerous efforts of recent social economy research initiatives).

Our response to these challenges involved two steps. First, we compiled two working papers: one that outlined the issues associated with social enterprise legal structure in Canada, and a second paper that presented a snapshot of social enterprise legal structure reform in the UK and US. While potentially biasing our questionnaire respondents, the papers provided a useful foundation upon which to engage participants on issues of legal structure – and how such changes may affect their organizations

(positively and/or negatively). Second, we expanded the scope of our search to find individuals with social enterprises who were willing to participate and who expressed knowledge of legal structure issues.

Our final sample included 20 social enterprise representatives whom we engaged in a questionnaire interview that enabled us to maintain question consistency, but also provided the option of a more general discussion about the issues (i.e. semi-structured).¹³ Fourteen of the respondents identified their organizations as non-profit organizations; three were a project of or an entire registered charity; three were taxable corporations. The geographic location of the social enterprises is as follows (including those with multi-jurisdictions):

- British Columbia – 8
- Ontario – 8
- Alberta – 2
- Saskatchewan – 2
- Manitoba – 0
- Quebec – 0
- Atlantic Canada – 6
- Territories – 2

The most significant gap in our sample is the omission of any participants from Quebec, especially given the advanced nature of the social economy sector in the province. We attempted to make contact with multiple Quebec-based organizations, in French and English, but were unable to secure a response within the timeframe of the data gathering process.

4 Findings

We have organized the interview results to best present the core thematic issues that arose through the data collection. While the majority of the social enterprise respondents were in favour of changing the legal structure of social enterprises, they and those who were against any reform highlighted a variety of pros and cons associated with a separate legal structure. It is our hope that these issues – and the arguments surrounding them – will provide insight to any reform processes that may emerge, and will highlight areas of needed education and outreach for the sector.

4.1 Definition

The literature clearly identifies the definitional obscurity surrounding the social economy and social enterprises. This is for good reason, as the sector is very diverse in terms of size, scope, orientation / purpose and governance. The main arguments emerging from the data speak to whether a specific legal structure for social enterprises will lead to a better and more unified understanding of what defines a social enterprise; or whether a specific legal structure will produce negative outcomes associated with limiting social enterprise diversity and activity.

¹³ With the exception of one participant who completed and faxed the questionnaire without any follow-up discussion.

4.1.1 Pro

The main arguments in favour of clarifying the definition of social enterprise through legal reform are twofold. First, respondents felt that a clarified legal structure will bring **certainty** to the sector. Given the flightiness of capital, any efforts to clarify the meaning of social enterprise and their functions will help to facilitate greater flows of investment into the sector. Second, a clear definition will also help to coordinate efforts surrounding presenting a specific **brand identity** to communities and investors. Legal reform will raise awareness of the social enterprise model and enable the sector to better coordinate its marketing and lobbying efforts.

4.1.2 Con

The main concern associated with legal reform leading to a more concrete definition of social enterprise is that it may have **unintended consequences**. There was common sentiment raised by respondents that more work needs to be done on understanding the sector first before rushing into regulatory reform:

If you want to regulate something, you first need to understand what it is.

If you can't answer the question of what it is, maybe you should not be trying to regulate it.

Issues of defining the social enterprise sector also revealed an overall core theme that will emerge in other themes below: a general concern, or skepticism, that the governments responsible for implementing legal reform will not “get it right”. This speaks of the necessity for quality consultation processes and support to coordinate and mobilize the sector, in order to respond adequately to reform initiatives. As one respondent stated in a warning on regulatory processes:

Those who do not run social enterprise, determine what social enterprise is.

4.2 Innovation

Closely related to issues of defining social enterprise is the fact that the sector is an emergent and highly innovative area of society and the economy. Emergence refers to the ability of a complex system to create new ways of organizing in response to changes in the environment, for example, a decline in government funding for social programs. Innovation refers to the ability to make something that already exists better. At its roots, the social economy is both proactively and reactively emergent and innovative, either advancing ideas and mechanisms for social, economic, cultural, and environmental development; or responding to changes in government supports for the delivery of various goods and services.

4.2.1 Pro

Respondents linking legal reform to an enhanced capacity for innovation cited four main issues. First, interviewees stated that a discrete legal structure would help to create a **common language** for social enterprise in Canada. The language would then bring a

semblance of order to the system that would enable innovative collaborations. The structure would bring a degree of innovative efficiency that could advance the system:

The legal structure and a common language would bring an efficient way for people that don't know what they are doing to get going – everyone knows what it is and it takes the confusion out of the system.

Second, respondents recognized that the Canadian structure could benefit from examples and experiences in other countries – i.e. **not needing to start from scratch**. There are existing innovative structures in other countries, notably the US and UK, that we could learn from and adapt to the Canadian context. There is emerging evidence that these other structures (the L3C, Benefit Corporation, and the CIC) have succeeded in attracting investor capital to social economy businesses. It is also clear from ongoing amendments to these structures that they will continue to adapt to better clarify their purpose and ensure compatibility within the existing business system (in addition to limiting the potential to abuse the structure).

Third, respondents understood that the legal structure would very likely evolve, through a period of **adaptation**. The sector and regulators can monitor the situation and seek to address any unintended consequences through regulatory amendments. An interesting suggestion here was to ensure that the structure was relatively simple with a limited number of components. This would then leave room for continued innovation within the social enterprise system and make any future adjustments easier to implement.

4.2.2 Con

Given that attention to the social enterprise sector is a relatively recent phenomenon, respondents were concerned that, given its emergent status, imposing a legal structure on social enterprises would effectively **inhibit or prevent possible future innovations**. In parallel, there was a common sentiment raised expressing “if it's not broken, don't fix it” – essentially, stating that the existing system is presenting **no particular barriers** to enabling a variety of social enterprise structures.

What problem are you trying to solve?

I don't think there is anyone I know who has been prohibited from starting a social enterprise. Corporate structure options are not a major barrier.

The current legal forms provide nothing that we could not get around.

These concerns relate also to themes outlined above concerning the possibility of **unintended consequences** negatively impacting social enterprise development. If the regulatory bodies get the structure wrong, it could override the positive and dynamic response capacity of the existing social enterprises.

4.3 Finance

Access to Capital

Proponents of a new legal structure for social enterprise often cite a heightened ability to access capital as a major feature. The sector more or less agrees that it is underfunded, and although the nascent social finance field may offer more opportunities, charities and not-for-profits cannot offer equity investment opportunities due to the limits of the structures themselves.

4.3.1 Pro and Con

The majority of respondents in favour of a legal structure for social enterprise viewed the attraction of new money as the key issue. However, there are pros and cons associated with each vehicle for accessing new funds.

...it would give social purpose business and social enterprises that are coming out of the non-profit sector an opportunity to raise additional cash, attract additional dollars, lever existing sources of money to attract new dollars to achieve social purpose.

Well I think in order for [a legal structure] to be really beneficial to the sector, it would have to allow organizations to access donations, grant money, and equity. Quite frankly, my opinion is that's almost impossible.

Access to Grants

The respondents seemed split as to whether the loss of access to grants is a deal breaker when considering a new legal structure. Most assume that the new structure would be a taxable corporation, hence limiting or cutting off access to non-repayable financial supports. Some viewed grants as more precious than any benefits that a new structure could offer, while others felt that grants would soon be a thing of the past in any event.

We won't be able to fund a CIC because they will be a for-profit corporation. Unless the CIC is owned by a charity even if the private benefits are limited [they] can't use charitable dollars to support private benefit. Perhaps if the charity is a 50% owner. So, this needs to be sorted with CRA.

Times have changed, it's the 21st century and we can't afford the luxury of relying on grants. That is a very key piece of it for me. It is definitely possible to do social enterprise using the current structures and my own organization has in many ways been a social enterprise since day one, although we are constrained by the non-profit framework.

Taxes

With respect to taxation, a potential barrier often expressed was that of jurisdiction. The contradictions between federal and provincial treatment towards profit within not-for-profits was cited as an example of the tensions that already exist. One respondent observed a 'clash' in current government approaches, while another hoped for 'collaboration between the two levels of government' if a new structure were to be introduced.

Questions were raised as to how governments might treat a proposed legal structure that embedded within it income tax rates lower than corporate ones. It was suggested that there should be a 'fair way of competing on the same basis as the private market'.

The tax incentive issue is intriguing, but a hard sell – this is where government is going to balk. It should be done in a fair way when competing on same basis as the private market.

[We need to] acknowledge that CRA's role is to raise [i.e. generate] taxes. I think we also need to look at what point does social enterprise enter the realm of becoming a tax paying institution. One of the challenges I find is that people think that because they are a non-profit, they should never have to pay taxes. So I think, why do you think that way, if at some point your activities are generating profits, why not pay taxes in a way that doesn't hurt the whole sector?

Those familiar with social enterprise structural limits mentioned the current confusion and restrictions that CRA may be placing on community-based organizations. There was a suggestion that charity / not-for-profit reform may solve many challenges, rather than a new structure.

If you're a charity or non-profit, both those classification of organizations that are interested in social enterprise are governed by regulation from CRA and those regulations are in the case of charities very badly articulated and misleading and act as [a] deterrent for people thinking that it's possible to do social enterprise. And, if they know that there is a possibility to do it, still the negative character or the obtuseness of the rules make people fearful that by going offside they risk [losing] their charitable status.

There was also a desire expressed for accompanying investment incentives to attract new money to the system.

My major concern is that it be done well and that it should have associated with it some form of tax benefit for people that invest in it.

4.4 Government

Central to the respondents' concerns about the impact of legal reform on the role of the public sector in the social economy is whether the reform is nuanced enough to facilitate access to a wider investment pool (as per above) *and* maintain necessary public sector investments and supports in the development and operation of different social enterprise initiatives. A simplistic division of social enterprises identifies those operations that are, via their operations, delivering a social service, and those organizations that are generating revenues indirectly to provide funds for the host agency. The important distinction is the ability of a social enterprise to generate profit and survive either on its own or through a blended values model that mixes external funding with revenue generation, to ensure organizational sustainability.

4.4.1 Pro

Those in favour of legal reform viewed government support in two main ways. First, they viewed the creation of a new legal entity as simply **one more vehicle** (or choice) that is available to a dynamic sector. The opinions here were less “either / or”, viewing legal reform as adding to the menu of choices for social enterprises. Respondents identified that existing mechanisms would still be available to charities and not-for-profits – nothing is being taken away.

Second, select respondents identified the general **trend of decline** for government funding (both for reasons of ideology and economic crisis) (Imagine Canada, 2010). The blunt reality of this perspective articulates that funding has to come from other sources. Legal reform would create a familiar template and a structure to facilitate non-government investment.

4.4.2 Con

Negative perspectives of the impact of legal reform on public sector involvement in the social economy are associated with one primary concern: that legal reform will be used as an excuse for funding cuts – **off-loading** – to the community sector. Governments would effectively prioritize market-oriented (neoliberal) solutions to social and environmental problems. The challenge is that many social and environmental services address critical areas of market failure and therefore are unlikely to generate enough capital for self-sufficiency.

The intent behind social financing is to give government a transitional out for supporting social purpose enterprises. Social services are the business of the government – to ameliorate the market failure of capitalism – so, when you even discuss it, you give government the out.

4.5 System Abuse

The issue of legal reform leading to greater abuses within the social enterprise system emerged as a cautionary note for regulators, and as a rationale for resisting regulatory change.

4.5.1 Pro

As per above, those in favour of regulatory reform cited concern that while innovative, the emergent nature of the social enterprise sector and its well-known capacity challenges may be creating conditions in which entities are operating “**offside**” of CRA rules.

4.5.2 Con

The cons associated with the potential for abuses within the system due to legal entity reform are threefold. First, respondents identified the risk associated with the new legal entity being **abused by for-profit companies** looking for a better tax rate, new ways to leverage private capital, or brand themselves as socially or environmentally progressive when their actions and products run contrary to the principles of social enterprise.

Any legal structures that combine charity or non-profit and private enterprise, will benefit private enterprise. That is the only outcome. It will not help sustainability of social enterprise, it will just give government an excuse to stop funding people.

Second, the new legal status may **expose social enterprises to the demands of private investors** that may not act as patient capital investors. For example, could private investors bankrupt a social enterprise due to their inability to return a high enough return?

Third, interviewees noted that the social enterprise sector holds a somewhat precarious existence. Any abuses to the system via the new business model **may unduly tarnish an important sector** just as it is solidifying its own existence.

If there is a potential to abuse the structure – you can guarantee that there are lawyers preparing to abuse the system. We see enough of it happening within the highly regulated (and more narrowly defined) systems in the charities world.

5 Conclusions and Recommendations

5.1 Education

Our findings hint at support within the Canadian social enterprise system for structural reform; however, given our small sample size, the results more reliably highlight the need for more education and awareness-raising with respect to the entire issue of social enterprise legal structure in Canada.

Our challenge in identifying knowledgeable respondents, combined with the ability of these individuals to offer compelling reasons both for and against change, in addition to readily stating their own levels of uncertainty about the reform process, speaks to the need to “get the process right”.

That said, there exist a variety of challenges associated with education and information sharing to address knowledge gaps in the sector:

1. While we have spent months on this research...we can readily sympathize with the sentiments of social enterprise practitioners that this is not an exciting topic. Social enterprise operators tend to place responsibility for these issues in lawyers' hands, many of whom are not expert in the area of social enterprise and related structural options and limits;
2. Some social enterprise operators may be hesitant to learn more, in fear of learning that their own organization has been offside for some time. This is the ‘ignorance is bliss’ argument that some operators suggested...albeit half-jokingly.
3. Most social enterprise operators are consumed by the day-to-day operation of their businesses. Structural and regulatory information is not necessarily viewed as the most important use of their precious time and resources.

Innovative curricula such as the US-based Structure Lab – a full-day workshop session whose end goal is for participants to establish the best structural fit based on their enterprise’s specific finance needs, assets, relationships, values, market interaction, governance, and growth – is in the process of being adapted to the Canadian context.

While nothing can replace the experience of ‘live’ workshops on the topic of legal structures for social enterprise, web-based and print materials may represent a better ‘fit’ for busy social enterprise operators. A tension exists between the costs to develop such materials, and a possible expectation from the sector for free supports.

Lawyers with expertise in charity law or business may not necessarily be intimate with legislative and regulatory realities associated with social enterprise. In addition to intentionally building this expertise where there is interest on the part of legal experts to engage in the material, a roster should be built of lawyers in Canada who possess this expertise now.

As noted above, one of the objections to the introduction of a new legal structure for social enterprise is that the structure will be misused, or that unintended consequences will result. A related objection to any structural innovation is that certain elements won’t work (e.g. the interest cap might deter investment). It is essential to release educational materials that acknowledge these fears while observing that few innovations are introduced that don’t require additional tweaking. Perhaps even more important is the message that new structures will not eliminate current options.

5.2 Approach to Legal Reform

If expanded efforts of consultation and education result in informed, broad sectoral support for change, the new structure should maximize benefits while being made up of as few components as possible to enable progressive adaptation. To be most effective, such changes should also be accompanied by supportive infrastructure and promotion, without diminishing the value of social enterprises not choosing the new structure.

Characteristics of a new legal form for social enterprise might include some combination of:

- Ability to sell investment shares
- Ability to host hybrid ownership (e.g. a social enterprise jointly owned by a charity and a private business)
- Ability to brand the social enterprise sector
- Ability to remunerate Directors, e.g. now, founders of non-profits and charities need to choose between control (e.g. serving on
- Status as a qualified donee – qualifies for grants from charitable organizations
- Caps (limits) on dividends and interest paid out
- Asset lock – upon dissolution, can only divest assets to another asset-locked body such as a charity or the new structure
- Light-touch regulation / ease of formation

- the Board) and remuneration (e.g. serving as staff)
- Ease of the social enterprise sector to track outcomes.
- Ability of the government to stimulate the social enterprise sector through income tax reductions, and other incentives
- Qualifies for investment tax credits
- Ease of use for program-related investing by foundations
- Wide definition of community-interest (e.g. as opposed to the four heads of charity)
- Reduced income tax rates or tax exemption
- Pass-through entity (each owner pays income tax based on their own legal situation)

It is essential to identify champions within government to work proactively with the sector to introduce structural innovations. Beyond typical government consultations (which tend to solicit written feedback only, with no personal interaction), a consultation on structure would work optimally if ‘workshopped’ at best, or flowed through a diverse sectoral committee of operators and thought leaders in social enterprise.

Beyond champions, however, it is necessary to establish institutionalized structures that are capable of being sustained beyond changes in governments, elected officials, and staff. Structural reforms should engender confidence within the system to encourage experimentation with new social enterprise forms. Without such certainty, changes become subject to ideological whims and will not attract significant market engagement.

Respondents raised concerns that given a general lack of government funds, any regulatory change would likely not be part of an overall strategy to support social enterprise development. This would represent a lost opportunity to attract operators, investors, and customers – and institutionalize social enterprise within the economy.

5.3 Future Research

The social economy has recently been the subject of intense research attention, primarily through the Social Sciences and Humanities Research Council of Canada (SSHRC) social economy hubs. This correlates with an increased interest in advancing the regulatory framework for social enterprise. Overall, the sector has been a focus of sustained attention, both academic and practitioner-based, which is driving an agenda of learning and advocacy.

In proposing ideas for future research, we are mindful of the feedback from respondents concerning their frustrations with being overly researched and not receiving adequate feedback from various initiatives. Nevertheless, there exist a variety of research topics that will help to reduce overall levels of confusion about social enterprise legal structure, and monitor progress and adaptation going forward.

- ‘Translation’ of research findings into effective education materials for social enterprise operators;

- ‘Translation’ of research findings into promotional materials to attract more purchasers of social enterprise goods and services to the space;
- ‘Translation’ of research findings to attract investors to the space;
- Investment in community outreach;
- Outreach to business and law schools, to engender greater interest and capacity directed to the social enterprise sector;
- Studies of ‘how’ new structural innovations were introduced in the UK and the US (players, steps taken, sectoral engagement, government involvement, etc.);
- Further research into options for structural change, including tracking the latest developments internationally, such as the evolution of the CIC in the UK, and the new Social Enterprise LLC;
- Ongoing evaluation to monitor impact and identify areas for adaptation.

Keeping in mind the advice of Ayres and Braithwaite (as quoted earlier), the law is best used when there exists clarity of intent and knowledge of context. The first step involves understanding the characteristics of the legal landscape in which the Canadian social enterprise sector operates. From this awareness follows an assessment of whether the landscape requires modification. Should reform be deemed necessary, participation from a broad range of actors within the system is required.

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7 Appendix A: The Community Interest Company (CIC), the Low Profit Limited Liability Company (L3C), and the Benefit Corporation

The following outlines key components of three social enterprise structures found in the UK and US. These entities provide insight into possible forms and functions associated with regulatory change in Canada – although we need to be mindful of the primacy of context (historical, legal, economic, cultural, etc).

7.1 Community Interest Companies (CICs) – features and benefits

In 2005, the Community Interest Company (CIC – commonly pronounced as ‘kick’) was introduced in England, Scotland, and Wales, specifically via legislative changes to the Companies Act 1985. At time of writing, there are over 5,000 CIC’s registered.

The CIC is essentially a ‘not-for-profit company’ (or profit-for-community company) that ‘combines the pursuit of a social purpose with commercial activities’. Typically, those choosing the CIC form are individuals, businesses, those operating community-based projects, and community groups.

The CIC is simple and inexpensive to incorporate, and features a low level of regulation. Its structure is that of a limited liability company, and it can be formed ‘new’, or can be converted from existing business forms (a standard corporation can switch to a CIC).

As a means to inject cash into the venture, a CIC can sell investment shares. Windfall payments to shareholders are not allowed. There is a dividend cap on returns on shareholder investment, for the purpose of ensuring that an adequate level of resources remain in the CIC, and/or flow to community benefit.

Unlike traditional companies (whose Directors can declare that a dividend be paid), the entire CIC membership must vote to declare dividend issuance.

In some circumstances (i.e. when a loan is extended to the CIC whose repayment is linked directly to the CIC’s financial performance), an interest cap exists.

In instances of dissolution, assets flow to the community, not shareholders or other private interests. This asset lock is a key feature of the CIC.

It should be noted that the light regulation and simple set-up exist mainly due to the fact that the CIC is not a registered charity. Net profits of CIC’s are taxed at corporate rates.

Broad community accountability is built into the CIC framework via the requirement to file an annual CIC report with respect to its operations and activities, which is filed on the public record.

In too many cases in Canada, the non-profit / charity impediments to remuneration for service on Boards of Directors (and therefore playing a governance role) forces

organization founders to choose between remuneration and governance. In the case of the CIC, founders and CEO's can serve on the Board, and Directors can receive reasonable remuneration. The CIC literature also notes this as a positive incentive to attract the most suitable people for management and Directorship positions.

7.2 Community Interest Companies – emerging issues

In April 2010, the CIC legislation underwent revision by its original writer, based on three years of experience, and from feedback of those operating CIC's.

The level of the dividend cap was said to present barriers to investment, as many were unwilling to engage in risk investment with a below-market potential for payoff. The maximum share dividend cap was increased from 5% above the Bank of England's base lending rate to 20%.

Similarly, the interest cap was criticized as too restrictive. The maximum rate of return that an investor can reap on a CIC investment was increased from 4% above the Bank of England's base lending rate to 10% of the average amount of a CIC's debt during the 12-month period preceding the due date of the interest.

There is also interest in changing the tax treatment of investments in CIC's to make them more attractive.

To our knowledge, there has been no systematic tracking of CIC impacts such as jobs created, and savings on the social safety net.

7.3 Low profit limited liability company (L3Cs) – features and benefits

The L3C is not a new legal form. Rather, it is a variation of the LLC, an already-recognized form in the US.

Unlike a corporation, owners are called members (rather than shareholders). Instead of (corporate) bylaws, LLC's (and therefore, L3C's) act under an operating agreement.

The L3C (as a type of LLC) is treated for tax purposes as a pass-through entity (corporations are taxed on their portion of L3C profits at the corporate tax rate, individuals at the personal tax rate, charities at zero, etc.). Likewise, members can be passive, or directly involved in management, as per the conditions of the operating agreement. Unlike a corporation, members (for instance, charities) can receive profits out of proportion to their investment.

Unlike the CIC, the L3C has no asset lock and no dividend cap.

Advocates are working to have L3C's accepted by the IRS as prima facie recipients of program-related investments (PRI's). These are *loans* flowed from American charitable foundations¹⁴, with the expectation of below-market (or zero) returns.

¹⁴ The investment power of Canadian foundation assets is dwarfed by that of American foundations, so it is unlikely that a Canadian incarnation of a social enterprise form would contain such a high stress on PRI's. Nevertheless,

Prior to the formation of the L3C, there was no standard legal form to accept PRI's from foundations. This meant that foundations exploring the possibilities of flowing PRI's to potential recipients had to obtain an individual ruling from the IRS, which could take years to attain, with an attendant cost of tens of thousands of dollars: not a very efficient use of time and money. With the L3C structure standing by to receive PRI's (and since PRI rules state that investments can take of form of LLC membership), it is hoped that no IRS involvement will be required.

Because the L3C can structure tranching (or layered) investments, some investments can receive below market (or zero, or even negative) rates of returns (foundations, social responsible investors) while others can receive market rates of returns (traditional investors). Likewise, some investments (e.g. PRI's) can be given ownership interests that are subordinate to the other investments (e.g. traditional investors). This tranching feature enables the attraction of a greater mix of financial backers, thereby broadening the variety and numbers of potential investors in the social enterprise.

7.4 L3C's – further commentary

The next steps in L3C development are a move to federal acceptance (i.e. sanction in even more states), beginning to attach tax incentives, advocating for L3C's to be recipients of investments under the *Community Reinvestment Act*, and to develop a roster of L3C's.

At time of writing, the L3C has been passed into law in Vermont, Michigan, Utah, Wyoming, Illinois, New York, North Carolina, Maine, and Louisiana. Legislation is being reviewed in Colorado, Georgia, Oregon, North Dakota, Tennessee, Arkansas, and Arizona.

Some ventures that have substantial private / financial bottom lines have adopted the L3C structure with the expectation of automatically being eligible to receive PRI's from foundations: many are therefore questioning whether the L3C structure itself will receive the IRS 'stamp of approval' as an automatic recipient of PRI's (which was the original intention behind this new structure).

7.5 Benefit Corporations¹⁵

In the United States, the term 'B Corporation' (the 'B' stands for 'Beneficial') is applied to a voluntary certification system created by a non-profit organization called B Lab, which describes the term this way:

Canadian foundations are beginning to examine PRI possibilities, so it may prove helpful to have a structure standing by that can easily receive these loans. See www.cfc-fcc.ca/programs/ri.html

¹⁵ Adapted from 'More Reflections on Legal Structure for Community Enterprise' by charity lawyer Richard Bridge, April 2010. www.centreforsocialenterprise.com/f/More_Reflections_on_Legal_Structure_for_Community_Enterprise_April_2010.pdf

'B Corporations are a new type of corporation which uses the power of business to solve social and environmental problems. B Corporations are unlike traditional responsible businesses because they:

- Meet comprehensive and transparent social and environmental performance standards.
- Institutionalize stakeholder interests.
- Build collective voice through the power of a unifying brand.¹⁶

Eighteen Canadian corporations have now been certified by B Lab as B Corporations. But this approach has some shortcomings. First, it is purely voluntary, and shareholders can ultimately revise incorporation documents to reassert shareholder primacy. Second, the certification system has no formal regulatory or enforcement authority and no legislative foundation. And third, it does not represent formal recognition by the state of the validity and importance of community enterprise.

It appears that these shortcomings have been noted by American legislators. In April 2010, the State of Maryland passed legislation officially enabling and legitimizing 'Benefit Corporations'. Vermont followed in September.

Key features of the new law are:

- Explicit recognition that public benefit purposes (e.g. positive environmental or community impacts) may be adopted by corporations;
- An obligation on directors to pursue those purposes and consider the interests of stakeholders (employees, community, etc.);
- Confirmation that the maximization of shareholder value is not the dominant duty of directors, and legal protection for directors who pursue public benefits;
- A requirement that Benefit Corporations publish annual Benefit Reports that document performance in achieving their public benefit purposes; and
- A 2/3 shareholder vote requirement for changes to the control, purpose, or structure of a Benefit Corporation.¹⁷

¹⁶ See www.bcorporation.net/about

¹⁷ See www.csrwire.com/press/press_release/29332-Maryland-First-State-in-Union-to-Pass-Benefit-Corporation-Legislation?tracking_source=rss