Renovate or Move?: The Question of Finding the Right Legal "Home" for Non-Profits and a Survey of Available Options

by

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Social Innovation 604

1. Introduction

In Module Three we were introduced to several concepts which could play a role in social innovation: social finance[1], social enterprise[2], social entrepreneurship[3] and institutional entrepreneurship[4]. These concepts provide interesting starting points for creating new structures, enterprises and innovations to address complex and even confounding social issues.

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1 ""Social finance", as defined by its pioneers in the American philanthropic community, is the active investment of capital in businesses or organizations that generate positive social and/or environmental impacts, in addition to normal financial returns. It goes beyond what has been called "socially responsible investment", which is essentially a passive approach to avoiding investing in companies that run counter to the values of the investor (think tobacco, nuclear weapons, etc.). Social finance, by contrast, is the deliberate engagement of investors (not just philanthropic or public sectors) in companies and community organizations that provide both an economic and environmental/social return. At its core, social finance (or its semantic cousins: "impact investing", "mission-based investing", etc.) is about incenting innovation." Alex Wood, "Social Finance: a Conservative opportunity?" IPolitics Insight, May 26, 2011 at http://www.ipolitics.ca/2011/05/26/alex-wood-social-finance-a-conservative-opportunity/

2 "Social Enterprise is a relatively new term that can be used to described a fairly common practice in the not-for-profit sector: using for-profit methods to support, enhance and/or achieve their non-for-profit objectives…. Social enterprise applies an entrepreneurial approach to addressing social issues and creating positive community change. The British government employs the following definition to distinguish social enterprise from traditional business enterprises: social enterprise is a business with primary social objectives whose surpluses are principally reinvested for that purpose in the business or in the community, rather than being driven by the need to maximize profit for shareholders and holders"." The Ontario Trillium Foundation Policy, Research and Evaluation Department, "Social Enterprise", January 22, 2008 at http://www.trilliumfoundation.org/en/knowledgeSharingCentre/resources/SocialEnterprise.pdf

3 "We define social entrepreneurship as having the following three components: (1) identifying a stable but inherently unjust equilibrium that causes the exclusion, marginalization, or suffering of a segment of humanity that lacks the financial means or political clout to achieve any transformative benefit on its own; (2) identifying an opportunity in this unjust equilibrium, developing a social value proposition, and bringing to bear inspiration, creativity, direct action, courage, and fortitude, thereby challenging the stable state's hegemony; and (3) forging a new, stable equilibrium that releases trapped potential or alleviates the suffering of the targeted group, and through imitation and the creation of a stable ecosystem around the new equilibrium ensuring a better future for the targeted group and even society at large." Roger L. Martin and Sally Osberg, "Social Entrepreneurship: The Case for a Definition", Stanford Social Innovation Review, Spring 2007 at 35.

4 "[I]nstitutional entrepreneurs: those individuals or networks of individuals who actively seek to change the broader social system through changing the political, economic, legal, or cultural institutions, in order that the social innovation can flourish (Dorado, 2005). Occasionally, individuals have the skills of both the social and institutional entrepreneurs, but generally it is wiser to think of actor nets or groups behind successful social innovation… Strategies for connecting innovation to these other opportunity contexts defines institutional entrepreneurship. This role involves a set of skills including pattern recognition, resource mobilization, sense making, and connecting (Dorado 2005). It involves a deliberate focus on "up-down" strategies of reflecting on and connecting to decision makers and opinion leaders in policy, economic, and cultural arenas, engaging and questioning the strategic context of their decisions. It also involves recognizing local and "front line" innovations that promise institutional disruption, and selling these to the decision makers/opinion leaders when windows of opportunity open (Burgelman, 1983). Institutional entrepreneurs therefore need to master a complex set of cultural/social skills (cognitive, knowledge management, sense making, convening), political skills (coalition formation, networking, advocacy, lobbying) and resource mobilization skills (financial, social, intellectual, cultural and political capital). Building capacity for social innovation in part involves increasing the representation of these skills among those interested in fostering broad-based change." Frances Westley, "Making a Difference: Strategies for Scaling Social Innovation for Greater Impact", The Innovation Journal: The Public Sector Innovation Journal, Vol. 15(2), article 2 at 14-15

Yet as I considered the use of such tools as social finance, or considered harnessing the energy of either social or institutional entrepreneurship in service of innovation, I began to be curious about the legal structures available to "house" these innovative enterprises and efforts, because these too are the "tools" of social innovators. Traditionally, social issues have been addressed by governmental initiatives, or by private philanthropic, charitable or non-profit organizations. Each of the latter grouping has its own legal structures through which they conduct their activities: trusts and foundations; charitable organizations with charitable registration status in Canada; and non-profit corporations. Each of those legal structures has its own characteristics and limitations.

Social entrepreneurship is a more recent arrival to this "housing complex" of legal structures, and while it is usually carried out through for-profit corporations, interest has turned more recently to adaptations of other traditional structures to new social enterprise purposes. We have seen the development of the "B Corp" certification process, and, in the United States, the development of "beneficial corporations" with their own statutory regime.

Closer to the context of the non-profit sector, we have seen the creation of new hybrid legal entities such as Community Interest Corporations or CICs in the United Kingdom and more recently in British Columbia[5], Community Contribution Corporations. In Ontario with the introduction of the Not-for-Profit Corporations Act, 2010, Ontario saw the introduction of the concept of "public benefit corporations". All of these concepts incorporate some form of "asset lock" or restriction on the dispersal of assets to other

5 British Columbia Bill 23, Finance Statutes Amendment Act, 2012

similar types of organizations. This asset lock structure draws them to the non-profit end of the legal structure spectrum. At the same time, they also permit the limited accumulation of profit for purposes associated with the main enterprise.

If we do consider these kinds of initiatives as a spectrum we might place for-profit corporations (and partnerships, although these are beyond the scope of my paper) at one end of the spectrum, and traditional non-profit corporations at the other. In between, ranging from the former to the latter, we might put B Corps, beneficial corporations (although a uniquely American phenomenon so far), then CICs, CECs and similar structures, then trusts, foundations, co-operative and non-profit structures of one kind of or another.

All of these structures are being developed to meet the demands for more flexible legal structures to carry out purposes which have been traditionally considered the domain of the non-profit sector, that is, enterprises with a social responsibility character.

I became curious about the features of these different structures, and therefore in this paper I set about trying to learn more about them in the Ontario context generally. More importantly, I wanted to know whether or not they were providing the necessary flexibility to the *non-profit sector* to continue to develop its capacity and to leverage its expertise to address the pressing social problems this course seeks to answer with social innovation. Hence, while I canvas a variety of structures in this paper, my main interest is in the non-profit sector and what we can do to create legal structures which will make it more viable and sustainable over the long haul.

The non-profit sector itself is a sizeable one in Canada. As Lynn Eakins and Heather Graham note in their paper “Canada’s Non-Profit Maze”,

> The non-profit and charitable sector in Canada is a significant economic force. It accounts for $90 billion in GDP and is six times the size of the automobile industry. Using data from Statistics Canada, the Wellesley Institute estimates that the core non-profit sector (excluding universities and hospitals) is three times the size of the automobile industry. We also estimate that the sector accounts for $12 billion in volunteer unpaid labour.
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> In Ontario, there are 45,000 organizations with annual revenues of $48 billion and just under 1 million paid staff (or $29 billion and 600,000 jobs when hospitals, colleges, and universities are excluded). Volunteer time amounts to the equivalent of another 412,000 full-time jobs. Moreover, the non-profit sector is the service delivery agent of choice for government services. The non-profit and charitable sector is clearly an important part of the Canadian economy and an enormous contributor to the quality of life in Canadian communities.[6]

As I considered the importance of the non-profit sector and our legal structures for that sector, several questions arose for me: Fundamentally, why do we have a non-profit corporate structure anyway? Why do we insist that the trade-off for favourable tax treatment be that they are restricted in their capacity to earn and distribute profits? When we do “loosen” the strictures around earning and distributing profits, why do we insist on asset locks and other restrictions in terms of how they deal with their assets? Will changes like the new Ontario *Not-for-Profit Corporations Act, 2010* provide more flexibility and ultimately sustainability for non-profits?

It is definitely beyond the scope of this paper to answer all these questions. I consider this really more in the nature of an exploratory essay, mapping out basic information about the structures, posing some questions, and providing a possible set of guideposts to further research (perhaps in the form of a thesis!). Nevertheless, I believe these will

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6 Lynn Eakins and Heather Graham, “Canada’s Non-Profit Maze: A scan of legislation and regulation impacting revenue generation in the non-profit sector” (Toronto: Wellesley Institute, 2009) at 6 http://wellesleyinstitute.com/files/Canada's%20Non-Profit%20Maze%20report.pdf

be the questions which must be answered for the full potential of social innovation and social and institutional entrepreneurship, not to mention social finance, to be realized.

This is a field ripe for further inquiry. As was noted in a 2010 paper entitled “More Reflections on Legal Structures for Community Enterprise”:

> On December 9, 2009, the Parliamentary Standing Committee on Finance, after engaging in a public consultation process, presented to the House of Commons in Ottawa a report entitled A Prosperous and Sustainable Future for Canada: Needed Federal Actions. One of the recommendations in the report is: “the creation of a corporate structure for not-for-profit organizations that would allow the issuance of share capital and other securities.”[7]

2. Why have Non-Profits?

A leading organization affiliated with Case Western Reserve University[8], whose mandate is education about philanthropy, the civil society sector, and the importance of giving time, talent and treasure for the common good, defines non-profit enterprise as follows:

> [A]n organization formed for “the purpose of serving a public or mutual benefit other than the pursuit or accumulation of profits for owners or investors. "The non-profit sector is a collection of entities that are organizations; private as opposed to governmental; non-profit distributing; self-governing; voluntary; and of public benefit" (Solamon 10). The non-profit sector is often referred to as the third sector, independent sector, voluntary sector, philanthropic sector, social sector, tax-exempt sector, or the charitable sector.”[9]

They advance theories about the reasons non-profits have risen to become such a distinct aspect of our economies, which include:

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7 “Richard Bridge, “More Reflections on Legal Structures for Community Enterprise”, BC Centre for Social Enterprise: 2010

8 Learningtogive.org

9 http://learningtogive.org/papers/paper41.html

> ***"Market failure*** - This theory is based on the premise that not enough people desire a service or program to attract for-profit corporations to provide such services. Also, the fact that an organization exists without a profit-motive instills trust in the constituent.
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> ***Government failure*** - The government will not provide a service because of high cost or limited interest by the public. If there is not a large presence of constituents demanding a response from government, then the government is not likely to act. A small group of individuals can create a non-profit organization to provide mutually desired services rather then [sic] trying to convince a majority of citizens to support such efforts. There is also a cultural resistance to "big" government. Citizens are skeptical about the government being involved in all aspects of community life.
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> ***Historical Theory*** - Communities in America were formed well before formal government. Citizens were forced to come together to address issues within their communities and work together to form a solution. Even when government developed a presence within a community, citizens were afraid of the bureaucracy and often sought out solutions through voluntary association. Religion also provides a strong foundation for charity and altruism through scripture and a sense of duty taught within the church.
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> ***Political Science Theory*** - Non-profit organizations provide an avenue for civic participation. People are able to assemble and work toward a common goal with an intent to benefit the public. Non-profit organizations provide an outlet for pluralism and solidarity."[10]

Lester Salamon in *America's Non-profit Sector*[11], concludes that the non-profit sector exists to serve four critical functions:

> "Service Provision: Non-profit organizations provide programs and services to the community. Often times, non-profits are formed or expanded to react to a community need not being met by the government. Non-profits also tend to have the ability to act faster than government in response to an issue. Non-profits do not have to wait for a majority of citizens to agree upon a proposed solution. Rather, they have the ability to react to a specialized need or a request by a small group of citizens.
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> Value Guardian: Non-profit organizations provide a mechanism for promoting individual initiatives for the public good (16). Non-profit organizations provide a means by which members of a community can take action in an attempt to change the community they live in. These actions may take the form of

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10 Ibid

11 Salamon, Lester M. *America's Non-profit Sector: A Primer*. (New York: The Foundation Center, 1999). Cited in http://learningtogive.org/papers/paper41.html

> developing a local neighborhood watch program or, on a larger scale, developing an organization that responds to world relief efforts.
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> Advocacy and Problem Identification : Non-profit organizations provide a means for drawing public attention to societal issues. Non-profit organizations make it "possible to identify significant social and political concerns, to give voice to under-represented people and points of view, and to integrate these perspectives into social and political life" (16).
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> Social Capital: In America, the non-profit sector can be seen as a bridge between capitalism and democracy. Non-profit organizations develop a sense of community among the citizens by providing a means to engage in social welfare."[12]

These theories offer convincing reasons for the existence of organizations which fill the needs, niches and gaps which non-profits do. Put simply, non-profits exist because society requires the services they provide.

But the theories for the existence of these organizations do not necessarily answer the question "why must the organizations which provide these services be not-for-profit?" Non-profits respond to the social demand that *some* kind of human organization meet certain kinds of needs when other forms of social organization (governments, for-profits) do not. We might even say that because for-profits do not respond to these needs, some kind of organization relieved of the burden of generating a profit is the most appropriate answer.

And yet that does not seem a satisfactory solution to the problem of sustainable, stable service provision either. In some domains, notably in Canada the general domain of health, there is a principled and long standing resistance to the idea of supplying such services through "for-profit" models. Making a profit from someone else's misery and ill-health is repugnant to us and I do not quarrel with that basic foundational principle.

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12 Ibid.

But this paradigmatic principle in the field of health does not explain why we generally prohibit organizations (through our corporate and tax laws) from generating profits *at all* for the purposes of attracting investment, for example through secondary but perhaps related activities, if such organizations carry out a social purpose within the non-profit structure. It does not tell us why non-profits must be membership based organizations, rather than share based. It does not tell us why non-profits *have* to be not-for-profit in every case and every situation.

3. Why Are Non-Profits "non-profit" anyway?

Non-profits are such an accepted structure in our economy and society that we might be forgiven for not thinking much about why they are non-profit in the first place. What is it about their origins which would make it almost axiomatic at this point that organizations performing a social function would almost always be structured as to be non-profit? Why is there such a divide between performing a social function and making a profit?

There are probably various psycho-social, political and economic reasons in western cultures that cause us to tend to think that making a profit is not compatible with performing a social function. In short, however (while deriving its analysis from the American experience), the following synopsis grounds the legal origins of non-profits in English law around the concept of charities:

> "The definition of charitable organization in American law can be traced back to the Statute of Charitable Uses (43 Eliz. I c4) enacted by the English Parliament in 1601, which has been described as "the starting point of the modern law of charities" (Douglas, 43). When the United States Congress met to develop the first federal income tax laws, they determined that non-profit organizations should be free from the burden of having to pay income taxes and also called upon society to support these organizations. Almost all non-profits are exempt from federal corporate income taxes. Most are also exempt from state and local property and sales taxes. Non-profits have received this status because they

> relieve the government of its burden, benefit society, or fall under the provision of separation of church and state. It is important to point out that non-profit organizations are not prohibited from making a profit. The IRS does however restrict what organizations can do with its "profits." All money must go back into the operation of the organization. Profits cannot be disseminated among owners or investors." [Emphasis Added]

Similar observations regarding the origins and development of the charitable sector (as the antecedent to the modern non-profit sector) in Canada have been made elsewhere.[13]

It is important to reinforce here that the term "non-profit" is not precisely accurate. As seen above, and as will be seen from the review of tax treatment of non-profits below, a non-profit corporation is not completely prohibited from making a profit. It can make one, within the tax law strictures, but it cannot distribute profits to investors. Non-profits are therefore cut off from one of the most basic ways in which for-profits raises necessary capital for development of the enterprise: investment through a share structure and return to investors through dividends, stock options and other forms of recompense for money provided to the corporation. In this way, it could be supposed that they are restrained from making a profit from other's misery or need. However, as will be seen, they are also constrained through corporate and tax laws from operating parallel profit generating activities under the same non-profit roof as their central social purpose enterprise, even if those activities would tend to make the non-profit self-sustaining and viable in the longer term.

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13 see for example: Keith E. Seel , "Boundary Spanning: A Grounded Theory of Sustainability in Canada's Non-profit Sector" University of Calgary, Thesis

Submitted To The Faculty Of Graduate Studies, 2006 at http://www.mtroyal.ca/wcm/groups/public/documents/pdf/npr06_bound_thesis.pdf

In a recent article in the Stanford Social Innovation Review, the authors succinctly define the differences between for-profits and non-profits in a way that demonstrates the traditional rationales for both:

> For-profits focus for the most part on shareholder value maximization and are permitted to distribute returns to investors. Non-profits singularly pursue a charitable purpose, and in return, governments offer substantial tax benefits. Non-profits also benefit from social legitimacy and goodwill that attracts grants, donations, volunteers, pro bono professionals, and other free or inexpensive resources.[14]

Perhaps the concept of "charitable purpose" as opposed to a non-profit purpose is an American conflation of the two. But a review of Canadian law suggests that this conflation is fundamental to Canadian non-profits as well. Historically then, the work now done by non-profits has been considered fundamentally charitable in nature (if not always in tax treatment). And with that historic charitable characterization I would hypothesize, came notions of what was appropriate behaviour for a social purpose organization and what was not appropriate behaviour. Charitable activity is centrally and chiefly concerned with assistance of those in need. If some activity is fundamentally charitable in nature, then I further hypothesize that our natural reaction to it is that an organization *ought* not to make a profit from that activity. I say "ought not to" because in some ways this is a judgment, not a self-evident category. By categorizing non-profit activity as historically and notionally arising from charitable activity, we make a further judgment about appropriate organizational behaviour for those non-profits, in effect extending the concept of charitable to cover all social enterprise or social purpose activity. The compelling question for me is whether this is the correct stance to take on social purpose enterprises?

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14 Julie Battilana, Matthew Lee, John Walker, & Cheryl Dorsey, "In Search of the Hybrid Ideal", Stanford Social Innovation Review, Summer 2012 at 52

In Canada as well while there is a legal distinction between a non-profit corporation and an organization with charitable status, there are also interrelationships between the two categories, often causing confusion and creating complexities for funding and sustainability of non-profits. But as will be seen, the two concepts of non-profit and charity are simply not necessarily synonymous in law, nor do they always mesh seamlessly. If we can more rationally consider the purposes for which non-profits exist, distinguishing those reasons more carefully from our notions of charity and appropriate charitable behaviour in organizations, we may be able to open more space up for innovation and experimentation with legal structures which could better answer the needs of organizations with social purposes, non-profits in particular. In other words, if as a kind of thought experiment, we could de-link these intertwined concepts of charity and non-profit, we might be able to see a way forward towards improved financial viability and sustainability for non-profits and the activities they carry out. We might then be better positioned to consider improved legal structures to house non-profit activities, and *then* return to a consideration of which features of the old non-profit paradigm, grounded in historic and legal notions of "charitable activity" we ought to preserve.

4. Existing Legal Structures for Social Enterprise

As identified in the MaRS paper "Legislative Innovations"[15] there are the following legal structures currently in place in Ontario, within which social enterprise and innovation are customarily expected to exist.

a. For-profit corporations

15 William Chung, Mark Convery, Kerri Golden and Allyson Hewitt, *MaRS White Paper Series: Social Entrepreneur Series-Legislative Innovations*, Toronto: MaRS, 2010

These entities are incorporated under the *Business Corporations Act*[16] in Ontario or the *Canada Business Corporations Act*[17] at the federal level. They are characterized by the following:

1. They enjoy legal "personhood" meaning they can act as a person would at law- buying, selling, owning, being held responsible generally for their actions (although there are crucial limitations) and being able to hold others, both corporate and real persons, responsible;

2. They enjoy, again generally and with certain limitations, the right to "limited liability"- meaning that the corporation may be held liable for wrongdoing and its assets made available in satisfaction of any debt found to be owing, but only the corporations assets are so available, not the personal assets of its owners/ shareholders, directors or employees[18]. In other words, the limits of the shareholders liability are restricted to any amount owing to the company in respect of their shares.;

3. They issue share capital as a key part of their strategy to access financial resources, which is an aspect of their capacity to bring the enterprise to scale and to scale up and out. While for-profits may be either privately held by a group of shareholders, or publicly traded on a stock exchange, this basic aspect of their finances remains the same;

4. Their shareholders have a right of participation, depending on the number and type of shares held, to participate in the business decisions of the corporation and/or more importantly to participate in the earnings of the corporation through dividends and the pricing of the shares;

5. They can earn a profit, and

6. They are subject to income taxation (as well as other forms of taxation including property and payroll taxes).

b. Non-profit corporations

These entities are incorporated in Ontario formerly through Letters Patent under the *Corporations Act*[19], and it is anticipated that they will be governed under the new *Not-for-Profit Corporations Act, 2010* as of the Fall 2012 (see discussion below); and

16 *Business Corporations Act,* R.S.O. 1990, c. B.16

17 *Canada Business Corporations Act*, R.S.C., 1985, c. C-44

18 Note that there are restrictions on this limited liability such as directors' liability for six months' unpaid wages, as set out in the *Employment Standards Act, 2000*, S.O. 2000, c.41, section 81, as amended.

19 *Corporations Act*, R.S.O. 1990, c. C.38

formerly under the *Canada Corporations Act*[20] at the federal level, now subject to the *Canada Not-for-Profit Corporations Act*[21]. They are characterized by the following:

1. They too enjoy legal "personhood" as a for-profit corporation does;

2. They enjoy a right to limited liability, again subject to certain restrictions, but certainly generally members of the non-profit do not risk their assets in satisfaction of the non-profit's debts;

3. Rather than issue share capital and have shareholders, they have members who must pay membership fees in order to join. In return, the members have a right of participation, in the business decisions of the non-profit;

4. They generally may earn a profit but the uses to which that profit may be put are limited to being in furtherance of the objects of the non-profit[22];

5. While they must file tax returns, they do not generally pay income taxes as a corporation[23].

c. Co-operative Corporations

They are incorporated under the *Co-operative Corporations Act*[24] in Ontario or the *Canada Co-operatives Act*[25] at the federal level. They are characterized by the following:

1. If incorporated, they too enjoy legal "personhood" as a for-profit or non-profit corporation does;

2. If incorporated, they enjoy a right to limited liability, again subject to certain restrictions, but certainly generally members of the cooperative corporation do not risk their assets in satisfaction of the co-op's debts;

3. They have members who must pay membership fees in order to join. In return, the members have a right of participation, in the business decisions of the co-op and a right to a portion of the distribution of any surplus:

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20 *Not-for-Profit Corporations Act, 2010*, S.O. 2010, c.15

21 *Canada Corporations Act*, R.S.C. 1970, c. C-32

22 "In certain circumstances, a not-for-profit corporation may engage in activities that are revenue producing and that produce a surplus, or "profit". However, such activities must be incidental to the principal objects of the corporation and in furtherance of the principal objects. For example, a hockey club may hold a dance to raise funds for new uniforms for the team. If, after paying the expenses, the dance produces a "profit", the monies belong to the club and must be used for the benefit of the club (i.e. to purchase new uniforms for its team)" (*Not for-profit Incorporator's Handbook*, *infra*, at 7)

23 A charity or not-for-profit corporation may be exempt from federal income tax either as a "non-profit organization" as described in paragraph 149(1)(l) of the federal Income Tax Act, or if registered as a charity within the meaning of section 149.1.(Ontario Ministry of Government Services, ServiceOntario

and the Office of the Public Guardian and Trustee for Ontario, Charitable Property Program of the Ministry of the Attorney General, *Not for-profit Incorporator's Handbook*, at 29.

24 *Co-Operative Corporations Act*, R.S.O. 1990, c. C.35

25 *Canada Cooperatives Act*, S.C. 1998, c.1

> "Some co-operatives issue securities to their members, and to restricted categories of non-members. There is no market for these securities. People who invest in co-op securities usually do so for the value the co-operative will provide them as members in making available goods, services, facilities or jobs rather than seeking income or appreciation in the value of their investment."[26]

4. They may incorporate as either a for-profit or non-profit corporation in order to carry out the co-operative business.

> "Co-ops can be incorporated with share capital, without share capital, as a worker co-op (with or without share capital) or as a non-profit (necessarily without share capital). Where co-operatives are incorporated with share capital, no offering statement is required for the basic membership share. For other classes of securities (subject to certain minimum statutory exemptions), before the security may be sold each prospective investor must be provided with an offering statement describing the security and containing disclosures required by the CCA Act." [27]

5. There is limited appreciation of capital. (That is, interest on loan capital and dividends on share capital are limited to a percentage fixed by the CCA Act or the articles of incorporation of the co-op)[28]

> "Since the main purpose of co-ops is to provide goods, services or jobs for their members, people do not generally invest in co-ops for speculative purposes. By law, co-op shares may appreciate in value only to a limited extent."[29];

6. The majority of their business must be conducted with their members. This is a significant feature or limitation of the co-op structure- it exists, much as a Community Interest Corporation (see below) to benefit the membership community which it creates;

7. Taxation on income will depend on the form of incorporation, since both for-profit and not for-profit incorporation is available to a co-op.

As the authors of the MaRS paper note: "[o]f the existing legal structures, the co-operative alternative is generally seen as closest to the notion of a Community Enterprise, as co-ops focus on the needs of their members and the development of their

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26 http://www.ontario.coop/all_about_cooperatives/coops_in_ontario April 28, 2012

27 http://www.ontario.coop/all_about_cooperatives/coops_in_ontario April 28, 2012

28 http://www.ontario.coop/all_about_cooperatives/coops_in_ontario April 28, 2012

29 Financial Services Commission of Ontario, *Co-operatives in Ontario: Guide to Setting Up a Co-operative*, Toronto: Financial Services Commission of Ontario, 2011 at 2

communities. A co-op is a special-purpose organization owned by members that use its services. The members share equally in the governance of the organization and any surplus funds (profits), which are generally distributed among members or can be donated for community welfare or used to improve services to co-op members. There are generally six types of co-ops operating in Canada: financial; consumer; service; producer; worker; and multi-stakeholder."[30]

Yet the co-op structure is itself subject to the limitations of its form. It does only exist to focus on the needs of its members and therefore generally is dependent on engaging involvement of potential users of its services and products *as members*. Not all potential customers or clients of an organization wish to become members of that organization even if that requirement is demonstrated to be negligible in terms of the transaction(s) involved. Mountain Equipment Co-op[31] might be seen as a co-op which has made the transition from solely a member based organization to a large scale commercial enterprise. I query though whether it has therefore drawn far closer to the for-profit end of the spectrum and away from the social enterprise nature of its origins?

As one author notes:

> "…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.

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30 *MaRS White Paper Series: Social Entrepreneur Series-Legislative Innovations*, supra at 2

31 http://www.mec.ca/AST/ContentPrimary/AboutMEC/AboutOurCoOp/CoOpFaqs.jsp for Frequently Asked Questions about MEC's co-op structure.

> 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, I believe that a co-operative structure can be an excellent choice. But without that critical mass and core, a co-operative structure is not an option."[32]

d. Business Trusts

Trusts are legal entities created by a "declaration of trust" which sets out the purposes of the trust, its intended beneficiaries, the number and identity of the trustees and their powers and obligations under the trust. It is not directly subject to any legislation, although the *Trustee Act*[33] in Ontario allows the trustees to seek the advice, opinion and direction of a court in the event of a deadlock or other problem in the administration of the trust. The trust form is a relatively ancient form of legal structure designed to hold and use money for a stipulated purpose and for defined beneficiaries. In its origin and evolution pre-dates the modern commercial age and the development of the corporation by several centuries. Nevertheless, it remains a legal form still in use today as a structure which can be used for certain kinds of beneficial activities. It is often used as a vehicle in conjunction with charitable status, in order to create structures which can most effectively use the financial resources available to them (see section below on Charitable Status).

The authors of the MaRS paper note, but ultimately reject the use of the Business Trust as a vehicle for social enterprise:

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32 "More Reflections on Legal Structures for Community Enterprise", supra at 4

33 *Trustee Act*, R.S.O. 1990, c.T.23

The use of a Business Trust as an intermediary, whereby the trust carries out the activity of a charity, is also an alternative that has been considered. Canadian lawyers Terrance Carter and Theresa Man of Carters Professional Corporation explored the pros and cons of this alternative in a paper titled Canadian Registered Charities: Business Activities and Social Enterprise – Thinking Outside the Box and concluded that while an intermediary Business Trust provided some opportunities for charities to establish a Community Enterprise-like structure, the governance for such an organization may be complex and create additional liability risks for potential trustees.[34]

e. The Current Innovation in Ontario: Bill 65 An Act to Revise the Law in Respect of Not-for-profit Corporations

The Ministry of Consumer Services introduced Bill 65 in a press release of May 12, 2010, as providing Ontario's 46,000 not-for-profit corporations with a "modern legal framework to enhance corporate governance and accountability, simplify the incorporation process, give more rights to members, and better protect directors and officers from personal liability."[35]

The *Not-for-Profit Corporations Act, 2010*[36] will govern non-share capital corporations, instead of the roughly 50 year old *Corporations Act*[37]. There is a five year transition period for non-profits of a social nature which were formerly governed by the *Corporations Act*.

The *Not-for-Profit Corporations Act, 2010* institutes a new regime for non-profits which draws on experience and innovations from other jurisdictions in an attempt to modernize the non-profit corporation in Ontario. Nevertheless, as will be seen, it is itself the subject

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34 *MaRS White Paper Series: Social Entrepreneur Series-Legislative Innovations*, supra at 2

35 http://www.carters.ca/pub/bulletin/charity/2010/chylb210.htm

36 *Not-for-Profit Corporations Act, 2010*, S.O. 2010, c. 15

37 *Corporations Act*, R.S.O. 1990, c. C.38

of several criticisms from organizations such as the Ontario Non-Profit Network. The Act is not yet in force, although it is anticipated to be proclaimed in force in the fall of 2012.

The *Not-for-Profit Corporations Act, 2010* contains the following interesting changes to the law around non-profits:

1. A Director, responsible for the operational administration of the Act will be appointed (Part I).

2. Not-for-profits will be entitled to be incorporated. Previously, incorporation was at the discretion of the Minister of Government Services (Part II).

3. Of particular interest in the context of social innovation, not-for-profit corporations will be permitted to have any purpose within Ontario's constitutional legislative authority, but may only have commercial purposes to advance or support their non-profit purposes (s. 8 (3))

4. The Act introduces the concept of a public benefit corporation which is subject to certain specialized rules under the legislation, the most important of which is a form of asset lock. A public benefit corporation is defined as:

> "public benefit corporation" means,
>
> (a) a charitable corporation, or
>
> (b) a non-charitable corporation that receives more than $10,000 in a financial year,
>
> (i) in the form of donations or gifts from persons who are not members, directors, officers or employees of the corporation, or
>
> (ii) in the form of grants or similar financial assistance from the federal government or a provincial or municipal government or an agency of any such government; ("organisation d'intérêt public") (s. 1).

It is possible for a not-for-profit corporation to be deemed a public benefit corporation under section 1 (2):

> Despite the definition of "public benefit corporation" in subsection (1), if a non-charitable corporation that is not a public benefit corporation at the beginning of a financial year receives donations, gifts, grants or similar financial assistance as described in that definition in that financial year,

> (a) the non-charitable corporation is deemed to not be a public benefit corporation in that financial year; and
>
> (b) the non-charitable corporation is deemed to be a public benefit corporation in the next financial year, as of the date of the first annual meeting of members in that next financial year. 2010, c. 15, s. 1 (2).

The asset lock is accomplished under sections 89 and 150 of the Act:

> 89. (1) No part of a corporation's profits or of its property or accretions to the value of the property may be distributed, directly or indirectly, to a member, a director or an officer of the corporation except in furtherance of its activities or as otherwise permitted by this Act. 2010, c. 15, s. 89 (1).
>
> (2) Despite subsection (1) and subject to the articles and the by-laws, a corporation that is not a public benefit corporation may distribute the fair value of a membership to a member upon termination of that member's membership. 2010, c. 15, s. 89 (2).
>
> …
>
> 150. (1) Upon a winding up [of the corporation],
>
> (a) the liquidator shall apply the property of the corporation in satisfaction of all its debts, obligations and liabilities;
>
> (b) after satisfying the interests of the corporation's creditors in all its debts, obligations and liabilities, if any, the liquidator shall distribute the remaining property,
>
> (i) *if the corporation is a public benefit corporation*,
>
> (A) if it is a charitable corporation, to a charitable corporation with similar purposes to its own or to a government or government agency,
>
> (B) if it is a non-charitable corporation, to another public benefit corporation with similar purposes to its own or to a government or government agency, or
>
> (ii) if the corporation is not a public benefit corporation,
>
> (A) in accordance with its articles, or
>
> (B) if there is no provision in its articles for distribution of property, rateably to its members according to their rights and interests in the corporation;

(c) in distributing the property of the corporation, debts to employees of the corporation for services performed for it due at the commencement of the winding up or within one month before, not exceeding three months' wages and vacation pay accrued for not more than 12 months, shall be paid in priority to the claims of the ordinary creditors, and the employees of the corporation are entitled to rank as ordinary creditors for the residue of their claims; and

(d) all the powers of the directors cease upon the appointment of a liquidator, except in so far as the liquidator may authorize the continuance of such powers.

4. "Part VII of the ONCA addresses the appointment of the auditor and level of financial review required of corporations under the ONCA. Subject to Section 75, the members are required to appoint an auditor at the annual meeting or a person to conduct a review engagement of the corporation. Section 75 of the ONCA, allows the members of a public benefit corporation to pass an "extraordinary resolution" as explained below to have a review engagement instead of an audit if the corporation had annual revenues in its financial year of more than $100,000 and less than $500,000. The members of a public benefit corporation may also pass an extraordinary resolution to dispense with the appointment of an auditor and to not have an audit or review engagement but only if the corporation had annual revenues in its financial year of $100,000. Where a corporation is not a public benefit corporation the members may pass an extraordinary resolution to have a review engagement instead of an audit if the corporation had annual revenues in its financial year of more than $500,000. The members of corporation that is not a public benefit corporation may also pass an extraordinary resolution to dispense with the appointment of an auditor and to not have an audit or review engagement if the corporation's annual revenue in its financial year is $500,000 or less. Note that the Regulations under the ONCA may prescribe different amounts than those stated in the ONCA. An extraordinary resolution under this section of the ONCA is one that is approved by at least 80% of the votes cast at a special meeting of members or consented to by each member of the corporation entitled to vote at a meeting of members. An extraordinary resolution only has effect for one year until the next annual meeting of members."[38]

5. As one legal commentator has summarized the situation of public benefit corporations under the Act:

"Public benefit corporations will be held to a higher standard than non-public benefit corporations in terms of being accountable for their financial activities because they receive funding from non-members:

The new Ontario Act sets out three basic rules for public benefit corporations:

38 http://www.carters.ca/pub/bulletin/charity/2010/chylb210.htm

> 1) The audit exemption limits are capped at a lower level than for non-public benefit corporations – members can pass a resolution to have a review engagement instead of an audit if the corporation's annual revenue is between $100,000 and $500,000. If annual revenue is less than $100,000, members can pass a resolution to dispense with an audit or review engagement.
>
> 2) No more than one-third of the directors can be employees of the corporation or any of its affiliates.
>
> 3) Any remaining property upon voluntary dissolution must be distributed to a another charity or to a public benefit corporation with similar purposes or to government."[39]

In sum with respect to the activities of the non-profit, the Act allows a limited form of commercial activity, but only to advance or support one or more of the non-profit purposes of the corporation. The non-profit will still, nevertheless be subject to the provisions of both the Federal and Provincial tax laws, as described above. There is the introduction of the concept of a public benefit corporation with a form of asset lock.

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39 http://millsandmills.ca/2011/02/public-benefit-corporations-and-soliciting-corporations-new-definitions-under-not-for-profit-corporations-legislation/

The Federal Act also contains provisions which would distinguish between different types of non-profits depending on the sources of their funding. While beyond the scope of this paper it is interesting to note that the same commentator notes regarding the Federal Act:

> "The distinction between a "Soliciting Corporation" and a "Non-Soliciting Corporation" is one of the unique features of the new Federal Act.
>
> A soliciting corporation is typically one that receives donations from public sources and/or government grants in excess of $10,000 in a single financial year.
>
> Public sources include:
>
> 1. Donations or gifts from persons who are not members, directors, officers or employees of the corporation or from the spouse, common-law partner, child, parent, brother, sister, grandparent, uncle, aunt, nephew or niece of such persons.
> 2. Grants or other similar financial assistance from the government; or
> 3. Donations or gifts from another corporation that would meet the definition of "soliciting corporation".

Once a corporation has been deemed to be soliciting, it continues as such for a three year period. If during that period there is another financial year over the $10,000 threshold, the 3 year period will start again.

There are five special requirements that impact soliciting corporations:

1. They must have a minimum of three directors, two of whom are not officers or employees of the corporation or its affiliates.
2. They must send a copy of the corporation's financial statements, public accountant report (if any), and any further information respecting the financial position of the corporation and the results of its operations required by the articles, the by-laws or any unanimous member agreement to Corporations Canada.
3. On dissolution, they must ensure that the assets of the corporation go to a "qualified donee" as defined by the *Income Tax Act*;
4. They cannot have a unanimous member agreement; and
5. They must follow specific rules for conducting their financial review including audits and review engagements.

…To have the new Act apply, a corporation must be continued under the new Act. Corporations will have 3 years from the proclamation date to complete the continuation process. Corporations that do not complete the transition will be automatically dissolved.

The Ontario Non-Profit Network levels the following key criticisms against the Act as currently drafted:

> "Unfortunately, in its current form, the Act does not provide adequately for the sector's accountability to communities and undermines the governance capacity of volunteer Boards of Directors. In sum it fails to support longstanding and effective governance practices that have evolved in the sector. Key changes we need to see include:
>
> • Members should not be allowed to pass binding resolutions on Boards of Directors. In all other corporate legislation, member resolutions are advisory and non-binding on Boards of Directors. Binding resolutions from members will place many Boards in difficult positions as member resolutions may be at odds with an organization's contracts and agreements with funders and community partners. Legislation allowing binding resolutions from members will be a huge disincentive to people considering serving on voluntary Boards.
>
> • A clear and permanent definition of public benefit corporation based on organizational purpose (not revenue source). This will ensure organizations working for public benefit have an ongoing accountability relationship with their communities and to differentiate them from member-focused non-profits existing to serve their membership. These two classes of organizations have different obligations and needs.
>
> • A permanent asset lock (non-distribution constraint on dissolution) for non-profit organizations providing public benefit, to ensure assets remain in the public domain for the long-term.
>
> • Make non-voting members non-voting. The act currently gives non-voting members a vote on key corporate issues. Our sector's longstanding practices should be respected and the sector should not have to face costly and complex restructuring to accommodate a provision imported from the business sector, where non-voting members have a financial interest in the corporation. Non-voting members in the non-profit sector have no financial interest, indeed in the sports sector all the participating children (over 3 million) are non-voting members, and in other sectors non-voting members are corporations, other community organizations or for example magazine subscribers that wish to support and affiliate with the non-profit."[40]

5. Taxation Issues

40 http://www.theonn.ca/the-ontario-not-for-profit-corporations-act-bill-65-a-brief-summary/

A fulsome discussion of the taxation in Ontario and Canada of either for-profits or non-profits is beyond the scope of this paper. However, some baseline facts are useful in comparing the two forms of organization.

Certainly it is accepted that for-profits are subject to a variety of types of taxation-corporate income tax, payroll taxes, and HST are three which probably come immediately to mind for any business owner. The basic corporate tax rate in Ontario is currently 15.5%[41]

Non-profits on the other hand are generally not subject to tax[42].

> "Non-profit organization status applies to entities that meet four requirements of section 149(1)(l) of the federal Income Tax Act. They must:
>
> (a) not be a registered charity;
>
> (b) be organized exclusively for social welfare, civic improvement, pleasure, recreation or any other purpose except profit;
>
> (c) in fact be operated exclusively for the same purpose for which it was organized or for any of the other purposes mentioned in (b); and
>
> (d) not distribute or otherwise make available for the personal benefit of a member any of its income (unless it is an amateur athletics organization).
>
> Entities that meet these requirements are exempt from income tax. They are not able to issue charitable tax receipts to donors in the way that registered charities can. Similarly, because they are not "qualified donees" as defined in the federal Income Tax Act, they cannot receive grants from registered charities."[43]

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41 http://www.cra-arc.gc.ca/ctao/ and see also: http://www.ey.com/Publication/vwLUAssets/Tax_Rate_Card_-_2012_Corporate/$FILE/Tax-Rates-Corporate-2012.pdf

42 IT-496R Tax Interpretation Bulletin, *Income Tax Act: Non-Profit Organizations*, CCRA, August 2, 2001, at 2. "1. In general terms, paragraph 149(1)(l) provides that the taxable income of an association is exempt from tax under Part I of the Act for a period throughout which the association complies with all of the following conditions: (a) it is not a charity (see ¶ 4); (b) it is organized exclusively for social welfare, civic improvement, pleasure, recreation or any other purpose except profit (see ¶s 5 to 10); (c) it is in fact operated exclusively for the same purpose for which it was organized or for any of the other purposes mentioned in (b); and (d) it does not distribute or otherwise make available for the personal benefit of a member any of its income unless the member is an association which has as its primary purpose and function the promotion of amateur athletics in Canada (see ¶s 11 and 12).

43 "More Reflections on Legal Structures for Community Enterprise" supra, at 4-5

Nevertheless, while embodying a social purpose, non-profits have important restrictions placed on them with respect to the ambit of their purposes as well as earning and distribution of profits, through current tax legislation, regulations and rules.

> "To qualify for exemption under paragraph 149(1)(l), no part of the income of an association, whether current or accumulated, can be payable to, or otherwise made available for the personal benefit of, any member of the association that is not a member described in ¶ 13. An association may fail to comply with this requirement in a variety of ways. *For example, subject to the comments in ¶ 12, an association would not qualify as tax-exempt if (a) it distributed income during the year, either directly or indirectly, to, or for the personal benefit of, any member; or (b) it has the power at any time to declare and pay dividends out of income.*"[44] [emphasis added]

Another tax-related financial barrier to utilization of the non-profit organization for an expanded role in social and/or institutional enterprise is contained in the purposes for which a non-profit may be organized and operated under Canadian tax law. Those purposes are "social welfare, civic improvement, pleasure, recreation or any other purpose *except profit*".

"In general terms, social welfare means that which provides assistance for disadvantaged groups or for the common good and general welfare of the people of the community."[45] While this definition may seem to mirror the concepts of social enterprise, or at least align closely with them, the Income Tax Act[46] requires that the non-profit be organized and operated *exclusively* for such a purpose. The carrying on of a trade or business which earns a profit must be "directly attributable to, or connected with, pursuing the non-profit goals and activities of an association"[47].

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44 Ibid, supra at 4

45 Ibid.

46 *Income Tax Act*, R.S.C. 1985, c.1 (5th Supp.)

47 IT-496R Tax Interpretation Bulletin, *Income Tax Act: Non-Profit Organizations*, CCRA, August 2, 2001, at 3

Indicia that would tend to prove the non-profit was not being operated exclusively for non-profit purposes include: “a) *it is a trade or business in the ordinary meaning, that is, it is operated in a normal commercial manner*; (b) *its goods or services are not restricted to members and their guests*; (c) *it is operated on a profit basis rather than a cost recovery basis*; or (d) *it is operated in competition with taxable entities carrying on the same trade or business*.”[48]

Conceptually then, should a non-profit enter the domain of a social enterprise, perhaps one which is already being occupied by a for-profit entity, notwithstanding that the non-profit brings expertise, purpose and capacity to the provision of social goods or services, as well as generating productive competition, the non-profit may lose its tax status. This loss of tax status can have severe repercussions for the viability of its core activities and its charitable status (see discussion below).

Even if the non-profit meets these requirements as regards its activities, it may yet be caught by the restrictions on profit accumulation and lose its non-profit tax status. This can happen if:

> …a material part of the excess is accumulated each year and the balance of accumulated excess at any time is greater than the association's reasonable needs to carry on its non-profit activities (see ¶ 9), [then] profit will be considered to be one of the purposes for which the association was operated. This will be particularly so where assets representing the accumulated excess are used for purposes unrelated to its objects such as the following: (a) long-term investments to produce property income; (b) enlarging or expanding facilities used for normal commercial operations; or (c) loans to members, shareholders or non-exempt persons. This may also be the case where the accumulated excess is invested in a term deposit or guaranteed investment certificate that is regularly renewed

48 Ibid

> within a year and from year to year, whether or not the principal is adjusted from time to time.[49]

In other words, there is no clear way for a non-profit to move out of its situation of being dependent, year by year, on grants, donations and other forms of funding (as opposed to investment through accumulation of profits and investment of same to provide stability). And this tax enforced dependent status hampers any non-profit's capacity to become viable and self-sustaining over the long run.

Co-operatives, insofar as they may be incorporated as non-profit, share these kinds of limitations as well.

6. Charitable Status

Many organizations carry on activities as charities, and as such are subject to particular tax rules governing their activities, taxation, retention and use of their capital and income, and their capacity to issue charitable tax receipts. Conceptually though, charities are not a variety of business or enterprise structure in the same way that non-profits and for-profits are. Charities may in fact be operated through a variety of legal structures, such as a non-profit corporation, a co-operative corporation, or a trust. Being a charity means the organization partakes of a specialized tax status.

Charities and non-profits are often confused, but they are not the same, especially in respect of their tax treatment and capacities.

> "The difference between charities and non-profit organizations is not always clear. While a non-profit organization need not be [tax] registered to be exempt from income taxes, a charity must be. Under the tax laws, an organization carrying on only charitable activities does not qualify as a non-profit organization. Because an organization carrying on charitable activities may not claim an

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49 Ibid.

> exemption as a non-profit organization, it must be registered in order to be exempt from tax. Most important from the donor's perspective, only registered charities can issue receipts for donations."[50]

A "charity" is for most intents and purposes in this discussion a term used in respect of the particular tax rules governing a particular tax registered enterprise.

> "Any charity is classified in one of the following three categories: charitable organization, public foundation or private foundation. Its status may be changed only with the consent or at the discretion of the CRA…
>
> For the charity to maintain the status of a charitable organization or foundation, no income may be payable or other-wise made available for the personal benefit of any proprietor, member, shareholder, trustee or settlor of the charity. A religious community's support of its members is not regarded as income paid to the members, but rather as a charitable activity in itself."[51]

This brief summary points to the fact that charitable status carries with it similar kinds of financial and economic limitations that non-profit status does: money may only be accumulated for a limited purpose without risking losing beneficial tax treatment. Perhaps this limitation makes more sense in a charitable context, where the whole point of the organization might be seen to be the accumulation of funds for distribution for a social purpose. However, this ignores the fact that many charities also provide products and services for the social good as well- they are part of the spectrum of legal entities which undertake social enterprise.

7. Tax Incentives for Social Enterprise

Although in the early development stages in Canada, we do have examples of tax incentives for social enterprise which illustrate the positive potential in the tax system to foster social enterprise. One such example exists in Manitoba.

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50 Deloitte & Touche LLP, Taxation of Charities, 2006 at 1

51 Ibid, at 1-2

The purpose of the Community Enterprise Development (CED) Tax Credit Program is to encourage Manitobans to invest in enterprises in their communities by providing a tax incentive, while providing community-based enterprises with access to equity capital.

The Government of Manitoba, through its Agriculture, Food and Rural Initiatives, offers a tax incentive system with the following features:

1. The incentive applies to community-based businesses looking for capital.

2. It permits the business to offer a personal income tax credit of 30% to Manitobans who invest in the firm.

3. The business must have the following characteristics:

- Net assets of less than $10 million
- Gross assets of less than $25 million
- No more than 200 employees (with at least 25% residing in Manitoba)

4. The company could receive a maximum of $1,000,000 in repayable capital.[52]

Nova Scotia has also enacted such tax incentive provisions.[53] In a comparison of the two provinces system, the authors of a recent paper conclude:

> "In short, a tax credit by itself is a powerful tool *in the hands of an aware and mobilized community*. But a tax credit alone will not solve the local development problems that a community must address."

The authors point to the synergistic effect of supports such as tax incentives, on community or social enterprise, but tax incentives alone (and perhaps obviously) do not create either the environment for or the means to engage (legally or financially)in social enterprise.

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52 http://www.gov.mb.ca/agriculture/programs/aaa21s04.html

53 Stewart E. Perry & Garry Loewen, "Equity Tax Credits as a Tool of CED: A comparison of two local investment incentive programs" in Making Waves, Vol. 20, No. 3, at 21-25 (Canadian Centre for Community Development: 2010) see: http://communityrenewal.ca/sites/all/files/resource/MW200321.pdf

8. Social Enterprise and Recent Legal Structural Innovations in Other Jurisdictions

Although not specifically or necessarily addressed to the needs of the non-profit sector, there are a number of legal innovations in other jurisdictions which attempt to address the structural problems associated with a strict division of legal, tax and financial characteristics between for-profits and non-profits.

a. B Corps

B Corporations, also sometimes referred to as Benefit Corporations, are not a new legal structure but a form of certification of existing for-profits which is intended to indicate alignment of the enterprise with socially and environmentally responsible business ethics. The concept originates in the United States and is a product of the work of B Lab.[54] Those ethics are defined by transparency, legally expanded corporate responsibilities to include consideration of stakeholder interests, and to give an increased voice to sustainable and for-profit social enterprise. B Corporations are certified by B Lab as meeting certain threshold requirements and in some cases exceeding those requirements. The “B Corporation” concept is in effect a form of third party accreditation designed to enhance the visibility and reputation of participating enterprises. It is in essence a form of branding, abeit branding with social utility. Nevertheless, it builds on existing corporate structures and is a commercial, not legislative response to the impetus of social enterprise.

54 *MaRS White Paper Series: Social Entrepreneur Series-Legislative Innovations*, supra at 5-6; see also www.Bcorporation.net

There are 27 B Corps certified in Canada as of 2011, and 476 certified in the US for the same time period.[55]

B Corporations do not receive any preferential tax treatment, although this is a goal of B Lab in the American context.

b. Beneficial Corporations

Although confusingly and similarly named to B Corps, Beneficial Corporations (also sometimes called Benefit Corporations as well) are in fact new legal structures for social enterprise which have been introduced in some US jurisdictions. "Beneficial Corporations represent a distinct legal corporate form for businesses, as enacted by relevant legislation, whereas B Corps are companies, regardless of legal form, that enjoy brand affiliation with B Lab, a US-based accreditation non-profit."[56]

In 2010 Maryland became the first American state to enact "legislation creating Benefit Corporations, a new class of corporations required to create benefit for society as well as shareholders. Unlike traditional corporations, Benefit Corporations must by law create a material positive impact on society; consider how decisions affect employees, community and the environment; and publicly report their social and environmental performance using established third-party standards." [57]

Without going into extensive detail, it is sufficient for the purposes of this paper to note that Beneficial Corporations are American creations designed to overcome the strictures created by jurisprudence in some US jurisdictions which requires that for-profits

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55 Canadian Task Force on Social Finance, *Mobilizing Private Capital for Public Good: Measuring Progress During Year One*, Toronto: 2011, at 10

56 Ibid.

57 CSRWire, "Maryland First State in Union to Pass Benefit Corporation Legislation", April 14, 2010, http://www.csrwire.com/press_releases/29332-Maryland-First-State-in-Union-to-Pass-Benefit-Corporation-Legislation

exclusively engaged in maximization of shareholder value and preclude preference of and maximization of social goals. In Maryland, the new legislation created a legal structure with the following characteristics:

Purpose

•shall create general public benefit

•shall have right to name specific public benefit purposes (e.g. 50% profits to charity, carbon neutral, 100% local sourcing, beneficial product to customers in poverty)

•the creation of public benefit is in the best interests of the Benefit Corporation

Accountability

•directors' duties are to make decisions in the best interests of the corporation

•directors and officers shall consider effect of decisions on shareholders and employees, suppliers, customers, community, environment (together the "Stakeholders")

•not required to give priority to any particular stakeholder

•have discretion to give priority to particular stakeholders consistent with general and any specific public benefit purposes

•standard of accountability is identical for operating and liquidity/change of control decisions

Transparency

•*shall publish annual Benefit Report in accordance with recognized third party standards for defining, reporting, and assessing social and environmental performance, including assessment of successes and failures in achieving general and specific public benefit purpose and in considering effects of decisions on stakeholders*

•Benefit Report delivered to: 1) all shareholders; and 2) public website with exclusion of proprietary data

Right of Action

•only shareholders and directors have right of action

•no third party right of action

> •Right of Action can be for 1) violation of or failure to pursue general or specific public benefit; 2) violation of duty or standard of conduct
>
> Change of Control/Purpose/Structure
>
> •shall require 2/3 majority vote[58]

This corporate form in Maryland requires the involvement of a third party accreditor, presumably B Lab, as part of its transparency requirements. Thus, the legal structure is linked to the certification efforts of third parties such as B Lab.

This legal form has also been legislated in New Jersey, Virginia and Vermont as of 2011[59].

> "The new laws permit companies to join the profit motive with the purpose of making a "positive impact on society and the environment." In their articles of incorporation, Benefit Corporations declare their public missions—things like bringing a local river back to life, providing affordable housing, facilitating animal adoptions or promoting adult literacy. Under the law they must go regularly before a third-party validator like B Lab, the visionary Philadelphia-based alliance of more than 400 so-called B Corps across the country, to prove that they are not only meeting their goals but treating their employees, customers, communities and local environments with the same respect as their shareholders. Benefit Corporations can lose their B Corp title and their legal status for not doing right by these standards."[60]

As Jamie Raskin notes in his 2011 article, the incentive to create and use such a legal model lies, as stated before, in the constraints of corporate law as it has evolved in many states:

> "Benefit Corporations can't be held liable by courts for failing to place profits over everything else. This is an important shift in law. The fear of shareholder litigation has driven many public-spirited businesses, most famously Ben & Jerry's, to take the high bid rather than the high road in a corporate takeover fight. Becoming a Benefit Corporation declares legal independence from the profits-über-alles model. More important, having Benefit Corporation status sends a powerful

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58 Ibid

59 Raskin, Jamie. "The Rise of Benefit Corporations," The Nation, 2011 June 8. http://www.thenation.com/article/161261/rise-benefit-corporations

60 Ibid.

> message to shareholders, employees, business partners and consumers about what kind of company you're running. The signal generates instant branding, internal cohesion, consumer enthusiasm and links to a vibrant national B Corp network that brings in more than $4.5 billion in revenues. (Some B Corps are even worker-owned, like Vermont's famous King Arthur Flour, which has almost 200 employees and may become the poster child for companies doing well in commerce, doing good in society and doing justice in the workplace.) The key to success here is a growing consumer demand for responsible commerce."[61]

c. Community Interest Corporations

Community Interest Corporations, or CICs, are a phenomenon of the United Kingdom and are a legislated response to the need for greater flexibility in the legal structures of social enterprises. In some senses, they represent a hybridization of what we would recognize as a "for-profit co-operative corporation", since they enjoy the features of both of these legal structures.

One legal commentator lists the benefits or advantages of a CIC as follows:

> "CICs are intended to be an alternative to charities and have a lighter regulatory regime than charities but will not have the same tax advantages.
>
> CICs are companies formed under the Companies Act 1985 (as amended) and are subject to that Act and company Law generally. The directors are also obliged to pursue profits in the normal way as if the company were an ordinary company under the Companies Act – it is the manner in which such profits are used, which differs between ordinary companies and CICs.
>
> CICs do not have any restrictions on their finances (other than the asset lock) or on their growth, as is the case with charities. They may operate in a quasi-charitable manner, which would not necessarily be the case with ordinary limited companies. CICs have no special tax advantages although governmental/lottery assistance may be available on a case-by-case basis.
>
> Community institutions that have not been incorporated and/or have not applied for charitable status could use CICs as a way of protecting their assets and profits. It would also provide the corporate veil for those individuals that run the institution.

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61 Ibid

> Charities must be established exclusively for charitable purposes, whereas CICs can be established for any lawful purpose, provided their activities are, broadly speaking, for the greater good of the community.
>
> The regulation of charities is more stringent than for CICs, although CICs are subject to Companies House regulation and regulation by the Regulator.
>
> CICs can operate more commercially than charities, but they can provide stakeholders with the assurance that the assets will be used for the benefit of the community."[62]

CICs are limited liability companies created under the *Companies (Audit, Investigations and Community Enterprise) Act, 2004*[63]*.* They are formed under the *Companies Act, 1985*[64] and are subject to the *Community Interest Company Regulations 2005*[65]. They have a unique regulatory body, and the Regulator is responsible for among other things, ensuring adherence to the statute and regulation, and certified such adherence. The objective of the Act is to create a recognizable "brand" for social enterprises using a limited company form[66].

> "CICs are governed by an independent regulator and must pass a "community interest test." They are community owned and led and while they offer a capped profit to investors, their assets are permanently "locked" within the CIC for community use. CICs are taxed like other companies but some are eligible for the same tax credits as those for small businesses. Since the introduction of CICs, over 4,000 have been registered in the UK."[67]

Key features of a CIC are the following[68]:

> 1. The primary objective of the company is to use its assets and profits for the benefit of the community (as opposed to profit maximization for shareholders). They may operate more commercially than charities but they must:

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62 http://www.biggartbaillie.co.uk/ideas--insights/all-articles/corporate/guide-community-interest-companies

63 *Companies (Audit, Investigations and Community Enterprise) Act 2004* (UK), 2004 c.27

64 *Companies Act, 1985* (UK), 1985, c.6

65 *The Community Interest Company Regulations 2005* (UK), S.I. 2005/1788

66 *MaRS White Paper Series: Social Entrepreneur Series-Legislative Innovations*, supra at

67 Canadian Task Force on Social Finance, Mobilizing Private Capital for Public Good, Toronto: 2010, at footnote 51

68The description herein is derived primarily from: *MaRS White Paper Series: Social Entrepreneur Series-Legislative Innovations*, supra at 6-8

a. pass a community interest test. This test means that "the Regulator must be satisfied that a reasonable person would consider that the purposes of the CIC's activities are ultimately directed towards the provision of benefits for the community, or a section of the community. The Regulations state that any groups of individuals may constitute a community if they share a readily identifiable characteristic that is not shared by other members of the larger community"[69]. Again, like a co-op, a CIC's foundational characteristic is not providing a service to the broader community which clients or customers can choose to use, but instead, providing a service or product to a defined community of members;

b. adhere to certain "asset lock" restrictions. An asset lock is characterized by the following:

i. CICs may not transfer assets at less than full market value unless they are transferred to another asset locked entity (ie. another CIC or a charity);

ii. payment of dividends (other than to another asset locked body) are subject to caps;

iii. dividends may only be declared by members, that is, directors may not do so without the support of the members;

iv. interest rates linked to the performance of the CIC are linked to the central bank rate and capped (ie. there is a legally limited rate of return);

v. on dissolution of the CIC surplus assets must be transferred to another asset locked body.

c. Disclose their activities annually through an annual community interest report placed on the public record.

2. *CICs do not receive any particular beneficial or preferential tax treatment and pay the usual corporate taxes.*

It should be noted that both the caps on dividends and interest rates as well as the absence of tax benefits for CICs are under review.

A fundamental aspect of a CIC is the "asset lock" provisions, which are mirrored in other versions of this kind of structure (see for example Ontario's new "public benefit

69 Ibid, supra at 7

corporations under the *Not-for-Profit Corporations Act, 2010*). The purpose of the asset lock is described by the UK CIC Regulator as follows:

> "Community Interest Companies (CICS) are limited companies, with special additional features, created for the use of people who want to conduct a business or other activity for community benefit, and not purely for private advantage.
>
> This is achieved by a "community interest test" and "asset lock", which ensure that the CIC is established for community purposes and the assets and profits are dedicated to these purposes."[70]

The Regulator has explained the utility of the asset lock also as preventing demutualization and "wind fall profits" being paid out to members, shareholders and directors of the CIC.[71] Others have suggested that:

> The asset lock will be established in legislation, and will prohibit CICs from distributing their assets or profits to their members, except to the extent permitted where CICs issue equity. The lock will not prevent CICs from using their assets efficiently in pursuit of community benefit; for instance, they will be able to use assets as collateral for finance. The regulator will be responsible for ensuring that the asset lock is maintained, and stakeholders who believe that it is being breached will be able to ask the regulator to take action.[72]

d. Community Contribution Corporations: the British Columbia Experience

On March 5th 2012, the province on British Columbia in Canada, introduced changes to the *Business Corporations Act*[73] to allow for a new hybrid type of company – the Community Contribution Company:

> "Community contribution companies would be structured to combine both benefits to the community and limited investor returns within the context of a traditional for-profit company. They would be incorporated with the flexibility and

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70 http://www.bis.gov.uk/cicregulator/

71 Regulator of Community Interest Corporations, "Community Interest Corporations: Frequently Asked Questions" London: 2009 at 4 http://www.bis.gov.uk/assets/cicregulator/docs/leaflets/09-1647-community-interest-companies-frequently-asked-questions-for-funders-leaflet

72 http://www.iknitlinks.org/what_is_a_cic.html

73 *Business Corporations Act*, S.B.C. 2002, c.57

> certainty of regular companies, but under legislation that ensures they primarily benefit the community. These companies would allow an alternative business model not currently available through a regular business, whose primary focus is making money for shareholders or a non-profit society.
>
> These companies would be subject to a higher degree of accountability than an ordinary company and required to publish an annual report detailing their social spending." [74]

The Community Contribution Corporation ("C3") is the first truly hybrid structure in Canada specifically designed for social enterprise.

> "C3s will be structured to combine benefits to the community and limited investor returns within the context of a traditional for-profit company. They will have the ability to attract capital while simultaneously ensuring that community benefit takes precedence. *C3s will not be tax exempt.* [emphasis added]
>
> C3s have three main differentiating features from traditional for-profit corporations under the BCA:
>
> 1. C3s will be obliged to devote a portion of their profits to community purposes, which are determined at the time of incorporation.
>
> 2. C3s will have restrictions on their ability to distribute profits. Dividends and other forms of investor returns will be restricted in a manner to be set by Regulation. C3s will also be subject to an "asset lock" if the company is dissolved, such that distributions of capital to investors will be restricted.
>
> 3. C3s will be subject to greater public accountability. Each C3 will be required to publish an annual report detailing its community benefit spending. In addition, any member of the public will be able to request access to a copy of a C3's financial statements.
>
> The C3 structure responds to an emerging demand for socially focused investment options and can help foster social enterprise investments."[75]

The legislative amendments permitting the creation of a Community Contribution Corporation are currently working their way through the legislative process, and

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74 BC Ministry of Finance, "Information Bulletin: B.C. introduces act allowing social enterprise companies", March 5, 2012 at http://www2.news.gov.bc.ca/news_releases_2009-2013/2012FIN0011-000240.pdf

75 Linda Parsons, "Canada: A New Era Of Social Enterprise In British Columbia: Proposed Amendments To The Business Corporations Act To Create 'Community Contribution Companies", Davis LLP, April 23, 2012 at http://www.mondaq.com/canada/x/173880/Corporate+Company+Law/A+New+Era+Of+Social+Enterprise+In+British+Columbia+Proposed+Amendments+To+The+Business+Corporations+Act+To+Create+Community+Contribution+Companies

regulations necessary to the full realization of the concept have yet to be passed. However, one legal commentator has noted the following details:

> "The Legislative Assembly in British Columbia introduced Bill 23 — 2012 Finance Statutes Amendment Act, 2012 which proposes changes to the Business Corporations Act of British Columbia (the "BCBCA"). These changes will result in a new category of share capital corporation known as a "Community Contribution Company" or "CCC". At the time of writing, the Bill has not yet received 2nd reading in the BC Legislature.
>
> The proposal introduces the new Part 2.2 of the BCBCA, entitled "Community Contribution Companies". It defines a CCC as follows:
>
> A company is a community contribution company if its notice of articles contains the following statement:
>
> > "This company is a community contribution company, and, as such, has purposes beneficial to society. This company is restricted in accordance with Part 2.2 of the Business Corporations Act, in its ability to pay dividends and to distribute its assets on dissolution or otherwise."
>
> "Community purpose" is defined for the purposes of Part 2.2 of the BCBCA to mean:
>
> > a purpose beneficial to:
> >
> > a) society at large, or
> >
> > b) a segment of society that is broader than the group of persons who are related to the community contribution company,
> >
> > and includes, without limitation, a purpose of providing health, social, environmental, cultural, education or other services, but does not include any prescribed purpose.
>
> Many readers will have heard of the "community interest corporations", or CICs, which were introduced a few years ago in the United Kingdom, as well as low-profit limited liability companies, otherwise known as L3Cs, which have been introduced in a number of states in the United States. The community contribution company is BC's suggestion for a similar entity. The new proposals include an asset lock on the assets of the CCC and will only permit limited return of assets to shareholders. The provisions also suggest that there will be limits on the dividends that could be paid to investors. It is unclear whether the proposals will require a cap on dividends paid or whether the restrictions will act as a floor. We know that both models were being considered.

> Much of the detail surrounding the rules, and what investments in a community contribution company will look like, are left to the Regulations under the BCBCA. To date, none of the Regulations have been released, or perhaps even drafted.
>
> *The one thing the new rules do not do is provide any type of special tax benefit to the community contribution company. If tax benefits are to accrue to the CCC's, they will need to be enacted, either under the provincial taxation statute or through the Income Tax Act (Canada). There has been talk of the BC Ministry of Finance introducing a special tax credit for investors in CCCs, but all is speculation at the moment."* [emphasis added]
>
> There is no doubt that there is great interest from all levels of government and in the sector itself in establishing greater flexibility from a regulatory perspective around revenue generation. Whether or not the CCC will effective in doing so is a question that will only be answered once the Act is enacted and the Regulations are published in detail."[76]

As can be seen from the commentary, much remains to be done with respect to BC's new legal form. But also apparent is the interaction between legal form and tax treatment- issues which have yet to be addressed in BC or elsewhere in the country. These tax treatment issues fundamentally impact the utility of any new legal entities created to provide structures for social enterprise. Yet they seem to be the last aspect of legal structures which is addressed.

The question which emerges is whether there is a case to be made for a hybrid entity which enjoys the capacity for limited profit-making and profit distribution so as to encourage investment, viability and sustainability, while at the same time enjoying limited tax free status as a non-profit, provided its activities remain reasonably within the ambit of the social enterprise functions the entity was created to advance? Other experts in the field suggest the answer to this is yes, as explored below in the section on destination taxation.

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76 Susan Manwaring and Kenneth Burnett, "BC Legislative Assembly Introduces New Community Contribution Company" Miller Thomson LLP, Charities and Non-Profit Newsletter, April 2012 at http://www.millerthomson.com/en/publications/newsletters/charities-and-not-for-profit-newsletter/april-2012#bc-legislative-assembly-introduces-new

e. Low Profit Limited Liability Company

This entity is an American innovation. It builds upon the existing limited liability company legal structures available in the US, and is "meant to fill the gap between non-profit (0 to negative 100% return) and for-profit entities (+5% return), thus targeting the 0-5% rate of return. Additionally, L3Cs are intended to be structured to allow for flexible ownership and allow for foundations to invest as program-related investments (PRIs) which can be used by foundations to fulfill disbursement quotas under US tax laws. Thus one of the basic purposes of the L3C form is to signal to foundations that the L3C would conduct its activities in a way that would qualify as a PRI."[77] They are taxed as flow-through entities like partnerships or sole proprietorships- the L3C does not pay tax on its income but its members pay tax on their distributive share of the LLC income, even if no funds are actually distributed to the members.[78]

In order to qualify as a PRI the L3C must significantly further the accomplishment of one or more charitable or educational purposes; no significant purpose of the company may be the production of income or the appreciation of property (although the company can earn a profit)l and the company must not be organized to accomplish any political or legislative purpose.[79]

The L3C is an innovative adaptation generated by the particular circumstances of US taxation and regulation of private foundations. It provides an interesting example of how innovation can increase access to funding for social enterprise. Particularly interesting is the financing structure it is intended to facilitate. The high risk, "backbone" funding for

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77 MaRS White Paper Series: Social Entrepreneur Series-Legislative Innovations, supra at 8

78 Ibid, supra at 10

79 Ibid, supra at 10

the L3C is provided by the foundation at below market rates of return. This absorption of the risk by the foundation is intended to position the L3C to seek other investors seeking a higher rate of return.[80] In effect, the foundation underwrites much of the risk of the enterprise, and presumably engages in longer term funding. It is not clear what this very close relationship between the foundation and the L3C does to the operation and governance of the L3C. It certainly creates a non-arm's length relationship between the two and is suggestive of an enterprise purpose-built to further an aspect of the foundation itself, or perhaps the foundation and the other investors, rather than an independently arising enterprise.

f. Flexible Purpose Corporation

The Flexible Purpose Corporation, also known as the Social Purpose Corporation, exists in California and Washington. It "requires boards and management to agree on one or more social and environmental purposes with shareholders, while providing additional protection against liability for directors and management."[81]

9. The Limitations of the Vantage Point

We could view the range of orderly, regulated business activity as falling along a spectrum from for-profit to non-profit (co-operative corporations falling somewhere in the middle, depending on whether they are incorporated as a for-profit or a non-profit), with associated beneficial and restrictive features all along the spectrum. With the advent of social enterprise and the interest in creating legal structures which will support and enhance social enterprise activity, there has been flurry of interest in new forms such as

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80 Ibid, supra at 10

81 Battilana, Lee, Walker, & Dorsey, ibid, at 53

CICs, C3s and L3Cs, as well as some interest in existing structures such as co-operative corporations.

Most variations and innovations, with the possible exception of the C3 in British Columbia and the public benefit corporation in Ontario, seem to be considered though from the vantage point only of the range of the spectrum currently occupied by for-profit enterprise. In other jurisdictions, much attention has been focussed on creating entities which loosen strictures on corporate purposes by combining some aspects of a non-profit, such as a social purpose, with capacities to earn and/or distribute profits, regulated in turn by an asset lock. Inasmuch as entities like CICs appear to be subject to the same taxation rules as for-profits, they can be seen as adaptations of the for-profit structure to a social purpose.

In a sense, these innovations *so far* often represent an impetus to re-design the for-profit world so that it can better embrace the ethos of corporate social responsibility, the double and triple bottom line and a consequently new way of doing business. They represent an effort to harness the capacities, skills and entrepreneurial ability of the for-profit sector in service to a greater social good, and they are clearly laudable and to be supported.

But it may be just as useful to come at the question from the other end of the spectrum: how can we preserve the best features of a non-profit, while allowing them to earn and distribute profits in an appropriate manner?

And, is there a corollary argument for continuing beneficial tax treatment such as is enjoyed by a non-profit in order to enhance the viability and sustainability of a hybrid

organization, given its presumably important social purposes and function? The focus on only one end of the spectrum of business activity (ie. for-profit) betrays a limited vantage point and ignores the expertise, capacities, skills, entrepreneurial abilities and management genius of the non-profit sector, not to mention its very large social and economic roles in our economy.

10. The Structural and Tax Constraints Placed on Not for-profits

Stated simply, the structural problems of the legal forms of enterprise organization which are reviewed herein all suffer from some limitation which makes them less than ideal for social enterprise or for an expanded, self-sustaining role for non-profits.

For-profits exist in a context of single bottom line and ROI pressures which make adoption of a double or triple bottom line based on SROI complex although certainly not impossible. While Canadian courts have not held Canadian for-profits to the same stringent standard as many of their counterparts in the United States , the MaRS Report notes: “The Supreme Court of Canada has recently rejected the view that in discharging their duties to the corporation directors must consider only the maximization of shareholder value (the “shareholder primacy model”). Thus it appears in Canada that directors are permitted to consider interests, in addition to the interests of shareholders, in discharging their duties to the corporation. *However, the extent to which directors are permitted to consider the interests of outside stakeholders is not entirely settled*.” This caveat would seem to indicate that Canadian for-profits *may* be subject to *some* the same legal duties that many of their American counterparts are: profit maximization for shareholders. But then again, they might not be. This uncertainty points to a need for a legal for-profit structure which assures participants that it is permissible to consider the

interests of outside stakeholders. But it does not answer the question of what the best legal structure for non-profits ought to be.

Non-profits are perhaps more constrained by the tax legislation, regulations and rules which govern them, but they too have some inherent structural limitations. They are fundamentally membership based organizations, not shareholder based organizations. While membership fees can represent a source of finances, they are usually limited by the fact that they do not offer a return on investment. As membership based organizations, non-profits may be closely held by a defined membership which enhances control of the overall organization and relieves it from the vagaries of a large and changing membership, but limits opportunities for building a membership based financial structure. The limitations on its capacity to earn and distribute profits also represent boundaries on its ability to become self-sustaining.

In terms of the financing and sustainability of organizations which wish to pursue a social benefit, as non-profits do and increasingly the social enterprise sector wants to, the structural differences and dilemmas are usefully summarized as follows (note that a “hybrid” in this context is an organization which attempts to combine the revenue and profit earning capacity of a for-profit with the social purpose of a non-profit):

> “If the organization becomes a non-profit, selling products or services, it may have to pay tax on revenues associated with those activities and it could also lose its tax-exempt status if the activities are sufficiently disconnected from its primary charitable purpose. Yet, if the organization becomes a for-profit, it may be discouraged from pursuing social impact by the pressures of competitive markets as well as fiduciary responsibilities that generally prioritize profit maximization over other concerns. In other words, hybrid entrepreneurs can claim the organizational benefits of only one of the multiple forms of value they create.

> Indeed, a hybrid that registers as a non-profit cannot access equity capital markets because it cannot legally sell ownership stakes to investors. But if a hybrid incorporates as a for-profit, it cannot offer the same tax benefits to donors as registered non-profits can, even if these approaches lead to the most effective social solution. Further complicating the choice is the reality that entrepreneurs cannot fully anticipate their future resource needs at the time legal registration choices are made, and thus risk being prematurely locked in to one sector or the other."[82]

In Canada, these conundrums were concisely illustrated by the Canadian Task Force on Social Finance:

> Canada's charities and non-profits are actively pursuing social enterprise as a means to generate revenues to expand their community impact – developing and testing innovative new programs, scaling up those that work, and creating jobs and opportunity for disadvantaged individuals and communities.
>
> These efforts are being frustrated, however, by a confusing patchwork of federal and provincial regulations that discourage these organizations from mobilizing business methods, capital, and entrepreneurship to advance their missions:
>
> • The Canada Revenue Agency (CRA) only permits charities to engage in "related businesses" – businesses that are run substantially by volunteers or that are "linked" and "subordinate to" a charity's purpose. However, there is no clear definition in legislation or regulation of what constitutes a legitimate linkage. Furthermore, charities that inadvertently contravene CRA policies risk deregistration and loss of 100% of their assets. Charities can establish separate forprofit corporations to generate revenues, but this is costly and onerous.
>
> • Non-profit organizations are subject to guidance from Canada Revenue Agency. Indeed, "it does not matter what the profit is used for, a 149(1)(1) can not have any profit earning purpose." This discourages organizations from using enterprises to generate program funds or improve their overall sustainability. In addition, non-profit organizations providing public benefit require legislative safeguards to ensure community asset retention similar to the non-distribution constraints on charities.
>
> • Co-operatives may engage in enterprise, but community-service co-operatives that wish to benefit from tax free non-profit status are constrained by the same rules as other non-profit organizations – i.e. restrictions on surplus-generating activity.
>
> • For-profit corporations are ideally suited to establish and run enterprises, but their primary objective by law is to maximize shareholder value. They may legally

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82 "In Search of the Hybrid Ideal", Stanford Social Innovation Review, *supra*

> add other social purpose objectives, but there are no legislative safeguards to ensure community ownership and retention of assets, if desired. Without standardized accountability frameworks for measuring and reporting on social impact, it is also difficult for investors to assess and compare competing investment prospects."[83]

Structurally, the result is a mess.

Non-profits exist to provide valuable and necessary services and products, but they cannot earn a profit in doing so. If they wish to earn a profit in any real sense, they must spin off a for-profit entity. In order for funds to flow back through to the non-profit, the for-profit may choose to donate some of its earnings to the non-profit, however, it will wisely look for some advantage for such a contribution. If not provided as an investment, the for-profit may seek a charitable donation tax receipt and advantage. In order to provide this, either the non-profit must achieve charitable status, or alternatively, as some social enterprises have done in my experience, will spin off yet another organization, a charitable foundation, to take in charitable donations and use them for purposes aligned with but not identical to that of the non-profit, which will have to become a charity in any case in order to receive the monies. In the end, there are at least three legal structures, each with its own governance, each with its own imperatives, each with its own costs- all spun off from the central activity of the non-profit. The opportunities for these other entities to diverge from the central activity of the non-profit and "take on a life of their own" is obvious.

While L3Cs in the US represent a response to this division of function as a result of structural and taxation realities, it perpetuates this division because the structure simply exists as a place for foundations to distribute their capital. It is a response to an existing

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83 Canadian Task Force on Social Finance, Mobilizing Private Capital for Public Good, Toronto: 2010, at 21-22

American conundrum but does not fundamentally shift the system which created the conundrum in the first place.

At its starkest, the problem in maximising and leveraging the non-profit sector's capacity to become an engine for social enterprise lies in the legislated structural, regulatory and tax constraints on non-profits which are imposed at both the provincial and federal levels in Canada. Perhaps it is simplistic to lay the problem out in this way, however, it seems almost as if we have a moralizing philosophy underlying our conception of the non-profit which is: if it's doing good, it can't earn a profit; and the corollary, if it's earning a profit, it can't be doing good.

Our tax structure rewards and supports a non-profit by exempting it from income taxation, so long as it generally does not earn a profit. And if it does earn a profit, it penalizes the non-profit by imposing tax and threatening its existence as a non-profit. How in such an environment could any entity become self-sustaining? A non-profit must, and does, by definition depend on the "kindness of strangers" through donations, grants and other forms of funding which in turn create an accountability quagmire, which sucks resources away from the main enterprise into endless reporting.

Similarly, while a non-profit could enhance its funding potential by becoming a charity, our rules around charitable status preclude this as an avenue to generate profit.

The question becomes: what structure or structures and what tax treatments could alleviate such unnecessary proliferation of legal entities and undue use of resources, and allow a non-profit to house all its activities under one roof? Or as close as "one roof" as we can get.

11. The Destination Test[84] Plus a Hybrid Corporate Form: A Possible Answer?

The Canadian Task Force on Social Finance endorsed a profits destination test as one way of rationalizing the complicated and antiquated tax regimes we currently operate under in Canada.

> "*The introduction of a profits "destination test" (similar to the UK example) would permit charities and non-profits (including community service co-operatives) to run related and unrelated businesses tax free, as long as all proceeds are directed to advancing their missions. This would replace the current confusing array of Canada Revenue Agency rules with a single, simple rule that would enhance transparency and be significantly more enforceable than the current regime. It would also permit all charities and non-profits to take advantage of opportunities to diversify and grow their revenues and impact while avoiding costly "workarounds" when it comes to structuring the organization and financing of social enterprises. At the provincial level, the Government of Ontario has adopted this approach, passing legislation (Bill 65, Not-for-Profit Corporations Act, 2010) that establishes a provincial profits "destination test" for charities in Ontario.*[85]

While it is not completely clear to me that the public benefit corporation aspects of the *Not-for-Profit Corporations Act, 2010* will *necessarily* imply destination taxation in and of themselves, since tax rules and legislation are creatures of both the Federal and Provincial level, these provisions are a step towards such a tax framework. The necessity of such a step is acknowledged in the Task Force's recommendations with respect to taxation and legal structures:

> "1. The Department of Finance should move to amend the Income Tax Act to establish a profits "destination test" treatment of related business, to serve as the primary regulatory mechanism for social enterprises established and run by charities and non-profit organizations.

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84 I am indebted to Bill Young of Social Venture Capital, for my introduction to this concept in a conversation April 25, 2012 in Toronto.

85 Canadian Task Force on Social Finance, Mobilizing Private Capital for Public Good, Toronto: 2010, at 22

> 2. Provincial governments should consider amending other relevant legislation and regulations where necessary to obtain an approach consistent with an application of the destination test."[86]

But tax frameworks alone will not address the structural and thus financial issues of non-profits. The Task Force acknowledges this when it goes on to suggest that:

> The current range of available corporate forms also poses challenges when it comes to accessing capital for social enterprises. While many charities, non-profits and co-operatives have found ways to work within the limitations of existing corporate forms, these workarounds are often complex, onerous in terms of staff time and legal costs, and result in capital obtained at higher cost than is necessary. In some provinces, like Quebec, governments have established intermediaries and incentives to help social enterprises access capital, but across the country contradictory provincial and federal legislation and policy, means that many charities and non-profits continue to experience significant obstacles. For instance, the BC Society Act explicitly allows some commercial activity, but to do so runs afoul of the federal Income Tax Act and the Canada Revenue Agency.
>
> As a result, there is a strong interest in examining changes to existing corporate forms, and in the potential creation of a new hybrid legal form to enable social enterprises to operate more efficiently and access the capital they need to grow."[87] [Emphasis Added]

These ideas are reflected in the Task Force recommendations:

> "4. The federal government should take the lead in establishing a consultative process to examine the need for a new class of hybrid corporation, subject to a community interest test, for social enterprises and, if appropriate, explore options for a made-in-Canada model. This process should leverage the recently launched consultations by the BC government around a proposed Community Interest Company model.
>
> 5. As part of this process, consideration should be given to the relative merits of 1) amending the Canada Business Corporations Act (and its provincial counterparts), allowing for the creation of a 'community enterprise company' within the for-profit corporate framework; or 2) creating an entirely new corporate regime for social enterprises at the federal and provincial levels. This could build on work already undertaken by the BC Centre for Social Enterprise and SiG@MaRS on options for a new "Community Enterprise Corporation" that would combine elements from different approaches, including legally-binding public

86 Ibid at 22-23

87 Ibid.

> benefit objectives, community ownership of assets, and capped dividends to investors."[88]

In keeping with these recommendations, the Task Force suggests a possible model for social enterprise:

> 1. Legally binding public benefit objectives that cannot be changed without regulatory approval;
>
> 2. Expansion of fiduciary duty of directors to include stakeholder and community interests;
>
> 3. Annual public reporting on activities, financial and other outcomes inherent to the organization's objectives;
>
> 4. Legally binding asset lock precluding the sale of assets at less than market value, but permitting their transfer to another asset-locked body (e.g. CEC, charity, municipality) with comparable public benefit objectives;
>
> 5. Legally defined cap on dividends and interest paid to investors/lenders;
>
> 6. A taxation rate and investor tax credits that recognize the CEC's public benefit mission and the restrictions above;
>
> 7. Eligibility to apply for "qualified donee" status for the purpose of receiving grants and/or program related investments from foundations, charities and governments;
>
> 8. Access to the government programs targeting SMEs; and
>
> 9. Opportunity to donate 100% of profits to a registered charity.[89]

This structure, which BC's Community Contribution Corporation may provide a real world example of, in combination with destination taxation, would offer considerable flexibility to an entity in terms of engaging in sustainable social enterprise.

Questions which readily arise include whether such a design offers a suitable vehicle into which a mature non-profit organization could transfer its operations. But these

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88 Ibid.

89 Ibid at footnote 55

transitional issues pale in comparison with the effort necessary to make the tax changes contemplated by the Task Force's recommendations, requiring as they do both Provincial and Federal interest and co-operation. Nevertheless, the current environment of fiscal restraint and increasing social demand probably is as optimal a convergence of necessity and motivation as we are likely to see.

As well, and here I may simply be being obtuse, I find the concept of the "asset lock", so often a feature of these innovative structures, almost a throw-back to the charitable paradigm out of which non-profits arose (as discussed earlier). It suggests to me that in return for being allowed to make a profit, and to use it to assist in generating investment for purposes of viability, a hybrid organization with an asset lock is nevertheless required to "promise" not to use this advantage or the money generated by it for any other purpose but the social purpose it was created for, and that "promise" is enforced through an asset lock. In short, "charitable-type monies" can only be used for a "charitable-type purpose". Yet, such a requirement is also achieved by limiting the purposes or objects of such an organization through corporate law, and by oversight of these entities to ensure they are abiding by their objects. And an asset lock ignores the fact, as has been mentioned, that without substantial changes in the tax treatment of such organizations, they will face difficulties in realizing the full potential of a hybrid organization.

An asset lock would make more sense if there was favourable tax treatment of the entity, for instance, by treating it as a non-profit or by using the concept of destination taxation. In that context, monies earned as a result of that favourable tax treatment might logically have restrictions on their use. We do not have examples of hybrid

organizations which are receiving such favourable tax treatment yet in Canada or any other jurisdiction that I was able to identify. But if, as is the case with the UK's CICs and apparently BC's C3s, such hybrid organizations are still treated as for-profits for taxation purposes, then the asset lock seems an odd feature and unduly burdensome. Why should what is essentially a for-profit corporation which is expressly permitted to have a social purpose be required to abide by asset lock provisions in the legislation, simply because it has a social purpose? Aside from branding and marketing advantages, the economic or financial utility of this structure is not immediately apparent.

On the other hand, where, as in Ontario, a public benefit corporations by definition is either a charity or receives some funding through donations and gifts which one imagines have been provided for that social purpose, the asset lock makes more sense. In that context, the asset lock is almost akin to conceiving of the organization as a trust, that is, a legal structure holding money for a particular purpose and for particular beneficiaries' benefit. In law, the monies it holds would be seen as being "impressed" with the trust's purposes and therefore restricted from any other use. Again though, unless we are reverting to a form of conflation of social enterprise with charitable concepts, I remain skeptical about the utility of in effect treating them like charitable trusts through asset locks.

12. Conclusions: The Need for Legal Innovation Across the Spectrum

The current fiscal and economic pressures on non-profits to continue to deliver social and community services point to the critical need for legal innovation in both the form of the enterprise and its tax treatment.

Legal innovation cannot just occur at the for-profit end of the spectrum. It must reach across the spectrum to the expertise, knowledge, skill and motivation of the non-profit sector.

Non-profits generate employment and are a significant portion of GDP – they are one of the engines of our economy and they provide services and products which no other entity or sector is providing or is willing to provide. Even with a loosening of the conceptualization of what business is for, not all niches of human activity will be occupied by for-profits because sometimes traditional ROI will be too little to interest or sustain a for-profit enterprise, even one which has as its objective social enterprise.

Non-profits already embody the corporate social conscience that for-profits social enterprise innovations are striving for.

Non-profits know how to provide the services and products which generate social well-being.

But non-profits currently do it with one hand and one foot tied behind their backs- we need to free them from an unduly moralistic view of their activities grounded in ancient concepts of “charity”. We need to let them use a full range of appropriate activities, including investment profit generation and return on investment, to sustain them and their vital activities into the future. This will necessarily entail creation of an appropriate legal structure for their activities, preferably one which will do away with the need for multiple structures (non-profit, for-profit and charitable foundation for example) with their financial and administrative duplications, inefficiencies and constraints. In addressing the appropriate legal structure, and in order to eliminate the need for undesirable

multiple structures, the tax regime governing such legal structures must recognize the need for continuing beneficial tax treatment of an acceptable social and/or community enterprise based range of activities, as well as the possibility of tax incentives to potential investors in such ventures.

We already have examples of possible legal structure innovations in British Columbia in particular, and we have tax concepts available to us in the form of destination taxation. The project of providing a better, more viable and sustainable legal structure in which to house non-profit activities is a large one, but the need is pressing, and the time may never be better than now in our current fiscal, economic and social environment.