

**To: The House of Commons Standing Committee on Industry, Science and Technology**

**Re:** *The utility of SREs in the Canadian context and the extent to which current CBCA incorporation provisions and structures facilitate the creation of SREs<sup>1</sup>*

**From: The Ontario Nonprofit Network**

Organized in 2007, the Ontario Nonprofit Network (ONN) is the convening network for the 59,000 nonprofit organizations across Ontario. ONN engages, advocates and leads with- and for-nonprofit and charitable organizations that work for the public benefit in Ontario. As a 7,000-strong provincial network, with a volunteer base of 300 sector leaders, ONN brings the diverse voices of the sector to government, funders and the business sector to create and influence systemic change. Approximately 25% of all Canadian nonprofit organizations are in Ontario.

### **Background on the Nonprofit Sector**

Public benefit organizations – from arts and culture, sports and recreation, newcomer settlement, housing, faith groups and many more – reach almost all Canadians. Core nonprofit organizations (without hospitals, universities and colleges) generate \$35.6 billion or 2.5% of GDP. The core nonprofit sector is one of the fastest growing sectors of the economy with an annual growth rate of 7.1% nearly doubling from 1997-2007. Contrary to common perception, 45.6% of the core nonprofit sector's revenue comes from sales of goods and services, and an additional 15.9% comes from membership fees. Government transfers from the three levels of government comprise only 19.7% with charitable donations at 14%.<sup>2</sup> In Ontario 88% of socially responsible businesses are operated by charities and nonprofits, 3% by cooperatives and 9% as for-profit corporations (4% of for-profit companies operate for a charity, with 5% as independent for-profit companies).<sup>3</sup>

### **About this Submission**

In this submission **we advise against proceeding with modifications to the Canadian Businesses Corporations Act to provide for socially responsible enterprises**. No hybrid legislation models currently exist that meet the needs of social entrepreneurs, investors, and governments. Emerging evidence is hybrid legislation models do not work for the purposes

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<sup>1</sup> The House of Commons Standing Committee on Industry, Science and Technology (the "Committee") conducted a statutory review of the CBCA in 2009–10. In June 2010, the Committee published a report that recommended that the Government consult on four issues: (1) rules relating to disclosure of executive compensation, (2) rules applicable to shareholder voting and participation rights, (3) rules regarding the holding and transfer of shares and insider trading, and **(4) rules applicable to the incorporation of socially responsible enterprises**. [...] *Submissions are invited on the utility of SREs in the Canadian context and the extent to which current CBCA incorporation provisions and structures facilitate the creation of SREs*

<sup>2</sup> *Imagine Canada; adapted from the Satellite Account of nonprofit institutions and Volunteering published by Statistics Canada in 2009.*

<sup>3</sup> *Inspiring innovation: The Size, Scope and Socioeconomic Impact of Nonprofit Social Enterprises in Ontario.* (survey data 2011), Community Economic Development Network

intended. Social entrepreneurs, investors and governments looking for blended returns (profit and social good) can undertake whatever agreements and contracts they wish under existing share capital corporate legislation. We recommend they be left free to experiment and evolve. In addition, British Columbia and Nova Scotia are implementing different variations of the UK Community Interest Company so we already have two experiments under way in Canada.

**We recommend the government focus instead on improving the capacity of socially responsible enterprises operating as non-share capital organizations to earn income** so they may grow their enterprises, attract capital and increase sustainability. Modernizing legislation and regulation impacting these organization's ability to raise essential operating revenues will also make these nonprofit corporate forms more attractive as corporate structures for new socially responsible enterprise.

**We recommend the government focus on improving access for the full spectrum of socially responsible enterprises to appropriate capital investment.** Socially responsible enterprises have special challenges and needs that require different types and structures for investment capital. Increasing access to well-designed capital funds and formats will do more to grow socially responsible enterprises than hybrid legislation.

### **Detailed Submission**

**Definition- Who we are including in socially responsible enterprises:** In this submission, we have defined socially responsible enterprises *as those enterprises that commit themselves to undertaking activities that provide a social good while generating the income to undertake their work.* Often referred to as social enterprises, these businesses are found within charities, incorporated as not-for-profit organizations, operating as cooperatives with a subset operating under existing business legislation.<sup>4</sup>

**What question we are answering:** To answer the Committee's question on this issue, we asked, *"what are the needs of socially responsible enterprises (SREs) and how could legislation and regulation applicable to them be improved?"* This is important as multiple pieces of legislation govern current SREs, so the CBCA can't be considered in isolation. Canada is in a unique position, unlike the UK, as we have nonprofit legislation here in addition to charities and co-ops. While we retain focus on the CBCA, some references and history are essential to understanding this issue.

### **Part I: SREs have a critically important compact with the People of Canada**

When you start to regulate and legislate in this area, it is critical to understand what makes a SRE fundamentally different from other businesses. While SRE's have always used the most suitable corporate form available, they have traditionally and most identifiably used non-share capital

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<sup>4</sup> We are not including business corporations engaged in philanthropic donations and/or corporate social responsibility initiatives as socially responsible enterprises - only the subset of businesses that have a social purpose as their core mission.

corporate forms. Most socially responsible enterprises operating in the charitable and nonprofit sectors bring to their work a common set of values and principles that are widely shared and understood. The public, funders and those working in the sector understand that SREs in their communities meet core criteria that demonstrate their commitment to the public good. These criteria are key to the *public trust compact* that exists between these organizations and their communities:

- The organization has a **public purpose** and mission;
- The organization operates for the **public good not personal gain**;
- The organization **reinvests any excess revenue** in its public mission; and
- The organization **retains its assets** in the public domain for the public good.

The public's involvement and trust in charitable and nonprofit organizations has been created over many years through the committed work of millions of Canadians working in their communities and with their neighbours. The strength of SRE is in building community wealth – the infrastructure that we could not achieve alone and to which we should all have access. This includes soccer programs, day cares, community centers, theatres and more.

Market activity is an integral part of these efforts, when it is directed towards the public good. For example, St John's Bakery hires people with disabilities; Family Service organizations provide employee assistance programs; the environmental group Watershed has developed and is marketing a more environmentally friendly septic system.

While all enterprises operate within the market, the clear, consistent and proven orientation towards public good is the distinguishing factor of the SRE. It is therefore critical that SRE's operating under business corporate legislation be true to the principles of SRE; otherwise the trust established with the public is at risk.

### **The Challenges of a Changing World**

**Changing Role of Government** - Canada has seen rapid changes in the capacity and role of governments in funding services and infrastructure for its citizens. One result is an increased interest in harnessing private capital, both philanthropic and investment, to finance work previously undertaken with tax dollars. From this focus comes the interest in making better use of private business models and investment to extend public benefit work.

**Changing sources of Revenue** - Meanwhile, there is clear evidence that nonprofits operating SREs need a more enabling environment for their enterprising activities.<sup>5</sup> Canadian regulation of charities, nonprofits and co-ops dates from a previous era before earned revenues became a primary source of income for nonprofit organizations. Existing charitable, nonprofit and co-op regulations stifle innovation and growth, inhibit nonprofit organizations from securing or enhancing their sustainability and limit resources for their mission work.

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<sup>5</sup>*Non-profit Organization Risk Identification Project* <http://www.cra-arc.gc.ca/tx/nnprft/qa-eng.html>

**Squaring the circle: Business Strategies – social purpose** - Despite much discussion about investors who want to address the challenging problems of our times while making money, there appear to be a number of barriers preventing significant investment even in promising SRE's<sup>6</sup>. Quebec is the one Canadian province that has been successful in facilitating investment in its socially responsible enterprises. It has accomplished this by concentrating on developing democratized community investment funds, rather than new corporate structures<sup>7</sup>. Even Britain, a leader in encouraging private investment in social good, has not yet found the formula to attract private investment<sup>8</sup>. Reconciling the expectations of investors with the realities of social development work is still a work in progress.

**Opportunities and Learning** - It is early days in these shifts. There is much to learn and there are many changes needed. A common focus of governments in this space is on creating a new dual-purpose corporate form that will attract private sector investors. These legislative initiatives are still in the experimental stage, but to date investors have not participated as hoped. Moreover, with the exception of the UK, up take of the new dual-purpose corporate forms by enterprises has been slow.<sup>9</sup> Meanwhile, here in Canada we have a robust core nonprofit sector that contributes 35.6 billion annually to the Canadian economy and is actively engaged in socially responsible enterprise. Moreover, these organizations engage millions of Canadians with exceptional expertise and goodwill in making their communities creative, resilient and inclusive.<sup>10</sup> These existing resources need to be maximized even as new SRE models are developed and tested.

## **Part II: Dual-purpose legislation in the CBCA - Should the Federal Government join in?**

Currently SREs can operate as share capital corporations (CBCA and For-profit Co-ops) or non-share capital corporations (Charities, Nonprofits, and Not-for-Profit Co-ops). Before adding yet another form of legislation, we should consider what the objectives are and whether changes to the existing legislative forms might achieve similar objectives. We should consider the three existing non-share capital forms and not just the CBCA: context matters.

New for-profit socially responsible enterprises want a better framework to support them do good, make a profit, and attract investors. Some new entrants and for-profit businesses wishing to work for social good are shying away from the restrictive nonprofit and charitable regulation and turning to business legislation as being more flexible. However, in the business arena they find a poor fit. They are not interested in maximizing profit at all costs and want to be seen as having a more balanced set of priorities. Young entrepreneurs want to be able to earn a profit as they build social good in communities. They also want to be able to attract investors to their enterprises.

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<sup>6</sup> Rutherford R., Von Glahn D. *A Fault in Funding*, *Stanford Social Innovation Review*, Spring 2014.

<sup>7</sup> Mendell

<sup>8</sup> Burn-Callander, R. (2013) *Autumn Statement 2013: Social enterprises granted tax relief* [Online] Available at: <http://www.telegraph.co.uk/finance/budget/10498795/Autumn-Statement-2013-Social-enterprises-granted-tax-relief.html> [Accessed on 8 February 2014]

<sup>9</sup> For US data Bernholz, L. pg. 24. *The Annual Industry Forecast, Philanthropy and the Social Economy BluePrint 2014* available at: [www.grantcraft.org](http://www.grantcraft.org),

<sup>10</sup> *Satellite Account of Nonprofit Institutions and Volunteering* (Statistics Canada, 2009)

What people want is clear- the best of both worlds- but the challenge is how do you achieve the balance needed?

***The jury is out on the effectiveness of dual-purpose legislation as an enabler of social innovation.*** In the United Kingdom and the US, new hybrid legislation has been developed. Here in Canada, British Columbia and Nova Scotia have developed variations on the UK model and Ontario is conducting consultations.

There are two approaches to dual-purpose corporate structures. The US model (there are three variations) is to establish a corporate structure where the corporation declares its intent to undertake a social good in its objects. This is needed in the US because of the success of shareholder litigation making Directors uniquely responsible for maximizing shareholder profit. Canada is not in a similar situation. The US model is minimalist. It does not require any fixed contribution to the social good, nor does it define social good. There has been little uptake of the new model<sup>11</sup> and concerns exist about the potential for misuse of the corporate form.

The UK model is more analogous to Canada as they have a similar public trust compact between the public, their charities and trusts. The UK model requires the dual-purpose company, or Community Interest Company (CIC), to reinvest in the social purpose. The CIC initially proposed 80% vesting and 20% paid to investors and are now at 65% public reinvestment and 35% private profit. In addition, they have just introduced a tax incentive for investment, as investors are not engaging as expected with social enterprises regardless of corporate form.

The UK legislation has a regulator and regulates the social purpose (reasonable person test), asset retention, limits on dividends and interest. Most of the companies (78%) operating under the UK CIC legislation operate like our nonprofit organizations with members, not shareholders, and use debt financing. (The UK does not have the nonprofit corporate form Canada has.) Ten percent of CICs used shares that allow uncapped dividend payments to asset locked bodies (we have 75% of for-profit company profit able to go to charities). Only 12% were using shares limited by the dividend cap.<sup>12</sup> It would be this latter group solely that would be accessible for private share purchases.

In Canada, B.C. has adopted legislation similar to the UK but has opted not to have a regulator, and only requires one social purpose among many. The legislation has only been in place for a year and uptake is very slow (#11). It is far too soon to tell if it will be effective. In Nova Scotia, regulations are still being developed. Their version of the UK CIC model has a regulator. The Nova Scotia legislation has not yet been proclaimed.

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<sup>11</sup> Bernholz, L. pg. 24. *The Annual Industry Forecast, Philanthropy and the Social Economy BluePrint 2014* available at: [www.grantcraft.org](http://www.grantcraft.org)

<sup>12</sup> *Changes to the Dividend and interest Caps for Community Interest Companies: Response to the CIC consultation on the dividend and interest caps*, [www.bis.gov.uk/cicregulator](http://www.bis.gov.uk/cicregulator), December 2013).

Prepared by MaRs

Jurisdiction	Social benefit purposes in addition to profit motive	Community Interest Test	Asset Lock	Dividend Cap	Reporting Requirements	Government Regulator	Tax credits
C3 (BC)	✓		✓	✓	✓		
CIC (NS)	✓		✓	✓	✓	✓	
CIC (UK)	✓	✓	✓	✓	✓	✓	To be announced in March 2014
Benefit Corporation (US – 19 states)	✓				✓		
FPC (US – 3 states)	✓				✓		
L3C (US -9 states)	✓						

### In Sum

The “hybrid” form risks satisfying no one. If it provides the flexibility wanted by social entrepreneurs, it provides insufficient accountability for the social purpose to satisfy governments, the public and investors. Yet to assure the social purpose requires so many rules and restrictions that entrepreneurs find it too cumbersome, and investors too limiting.

Canada has a unique mix of corporate forms. It has charities, but it also has nonprofits and nonprofit co-ops on the non-share capital side. All of which are deeply committed to reinvesting all revenues in their work. On the share capital side, we have for-profit co-ops and business corporations. We have modern non-share capital legislation in the Canada Not-for-Profit Corporations Act (CNCA) and the Ontario Not-for-Profit Corporations Act (ONCA) (when the ONCA is proclaimed). We have co-operative legislation and our business legislation, both federal and provincial, is flexible and can be tailored to achieve social purpose through corporate objects and shareholder agreements.

We know from experience that different socially responsible businesses require different corporate forms and that having the range of choice is important. We can have that choice if existing corporate forms are modernized to better support socially responsible enterprises. We believe our existing corporate forms may be sufficient for many, if modernized and more attention is paid to developing and enabling sector specific capital finance models. Quebec has had great success focusing on financing for socially responsible enterprises and other provinces are beginning to following suit.

## **We recommend:**

1. **Free up our existing SREs – Non-share capital organizations working for public good (charities, nonprofits, nonprofit co-ops) must be allowed to earn what revenues they can to support their work and they should be supported and enabled to raise capital from their members and supporters.**

Once nonprofits are freed up to engage in socially responsible enterprise, the Canada Not-for-Profit Corporations Act, and the Ontario Not-for-Profit Corporations Act may well prove to be very attractive structures for social innovators, since they are modeled so closely after the CBCA, with the exception of share capital. Dual-purpose legislation may not be needed or only needed in specific situations.

Moreover, enabling socially responsible enterprises flexibility within the existing non-share capital corporate forms would ensure the accumulation of public capital within communities, and social innovations would remain in the public domain. A few socially responsible enterprises may need still more flexibility. They can experiment with the CBCA to build in social purposes through trust and shareholder agreements.

2. **Facilitate the raising of capital by socially responsible enterprises across the non-share and share capital corporate spectrum so innovators can obtain critical financing for their growth and development.**

SREs need access to a wide variety of capital and supports at different stages of their development. Some of the changes are regulatory, others are incentives. The SREs have identified a need for slow money, pooled funds, crowd funding community bonds and loan guarantees, RRSP eligibility for social investments, grants and tax incentives.

### **TECHNICAL BRIEF: Setting Out Legislative And Regulatory Changes for Non-share Capital Corporations to enable socially responsible enterprises and social innovation**

Little attention has been paid to enabling existing and emerging social enterprises, operating exclusively for the public good, as charities, nonprofits or nonprofit co-ops undertake in their work.

As the Province of Ontario's social enterprise strategy has identified, "Interest in social enterprise as a means of enriching the social fabric of communities is growing exponentially." However, the infrastructure for non-share capital corporations has failed to keep pace with entrepreneurial development.

The recommended changes are set out in three sections:

1. *Exempted revenues under the Income Tax Act*
2. *Soliciting Corporations under the Canada Not-for-Profit Corporations Act*
3. *Provincial Amendments*

## **1. Exempted Revenues under the Income Tax Act (ITA)**

In an environment of government spending cuts, the long-term financial stability of non-profits and charities hinge on their ability to earn income. For these organizations, revenue-generating related business is a means to finance their social objectives and deliver services to their community.

Nonprofits, even those providing public benefit, are restricted in their ability to generate revenues to support their mission while remaining tax exempt. The ITA requires that nonprofits operate exclusively for a purpose other than to generate profit. Any profits that are earned must be *incidental* to and arise from the primary activities that support the nonprofit objectives.

Recently, the CRA released the findings from its *Non-profit Organization Risk Identification Project*. The CRA noted that nonprofits were carrying out a variety of activities with apparent profit-generating motives and suggested that many nonprofits would fail to meet the definition of nonprofit organizations under the ITA. It went on to deny the long-standing understanding of the sector that profits generated to further organizational purpose were tax exempt and clarified that any intention to earn a profit, regardless of how those funds are directed, may land an organization offside the incidental profit rule.

A destination of funds test for related business and incidental profits needs to be codified to create an environment that would enable corporations providing public benefit to finance their core community purposes and to maximize social impact.

**RECOMMENDATION:** To ensure the long-term sustainability of nonprofit organizations and to foster socially responsible enterprise more generally, we recommend the following:

- 1. Nonprofits providing public benefit:*** Replace the requirement that nonprofits operate *exclusively* for a purpose other than to generate profit and that any profits that are earned must be *incidental* to and arise from the primary activities. Instead there should be a *requirement that NPOs operate for a purpose other than to generate profit and any profits earned be used for activities that support their nonprofit objectives.*

## **2. Soliciting Corporations under the CNCA**

The Canadian Not-for-Profit Corporations Act does not provide the necessary assurances that soliciting corporations that are not charities have a long-term commitment to building community wealth.

Regulation by the CRA of charities ensures that they operate exclusively for the public benefit. There is no analogous regulation of nonprofits and despite common belief, not all nonprofits operate for public benefit – some operate exclusively to benefit their members and distribute their assets among them upon dissolution (membership-based nonprofits).



Under the CNCA, a soliciting corporation is defined as including charitable corporations, foundations, and all nonprofit corporations that receive more than \$10,000 in a year in arms' length donations or government grants, gifts, or financial assistance. This current definition means many membership-based nonprofits will be deemed a soliciting corporation if they accept a single government contract for a relatively nominal fee; while at the same time, many nonprofit organizations serving the public benefit will fail to meet the definition.

## RECOMMENDATIONS:

1. Provide a **clear definition of “soliciting corporation”** which includes the following qualifying criteria:
  - a. The organization must have a public purpose and mission;
  - b. The organization operates for the public good and not personal gain;
  - c. The organization reinvests excess revenue in its public purpose; and
  - d. The organization retains its assets in the public domain for the public good.

These qualifying criteria ensure that member-based nonprofits are not captured by the definition of soliciting corporation.

2. Repeal the ‘test’ included in the current definition of “soliciting corporation” which deems corporations having received \$10,000 in a year from government or arms' length donation as soliciting corporations. Replace it with a **non-revocable self-selection test**, whereby nonprofits can choose to become a soliciting corporation and must meet the above-stated qualifying criteria.

Using the self-selection test, qualified nonprofits will have the right to **opt-in** to be a soliciting corporation. Those qualified nonprofits will have to weigh whether the conditions and benefits associated with becoming a soliciting corporation best serve their mission and structure.

The non-revocable nature of the soliciting corporation designation ensures accumulated assets will be retained in the public domain and guard against member distribution of community wealth upon dissolution.

### 3. Provincial Amendments

In addition to the proposed amendments to be implemented federally, additional changes are needed that fall under provincial jurisdiction. Changes are needed in the following areas to support the efforts of charities, nonprofits and co-operatives operating for the public benefit.

1. A clear exemption from prospectus and dealer registration requirements for non-profits;
2. Expanding the ceiling for offering statement exemptions available to Co-operative Corporations under the Co-operative Corporations Act;



3. Include in the Ontario Not-for-profit Corporation Act (ONCA) provisions for the issuance and oversight of community bonds by the Financial Services; Commission of Ontario congruent with the Co-operative Corporations Act;
4. Revise the ONCA to include a clear definition of “public benefit corporation”;
5. Revise the ONCA to include a non-revocable self-selection test for qualifying public benefit corporations; and
6. Amend the criteria for the investment standards (“the prudent investor test”) under the Trustee Act to include social goals.