Introduction

The topics being discussed by this Committee are far-reaching and focus on the much needed modernization of the regulatory framework governing registered charities, non-profit organizations, and other similar groups.

This brief will focus on one aspect of this modernization project - the funding of the charitable sector – and will focus in particular on new sources of funding, including social finance, social enterprise and hybrid organizations/structures.

The main points to be discussed are:

1. **Social Finance** – Regulatory change to encourage investment in charities and NPOs and to enable greater innovation in financing vehicles.

2. **Social Enterprise/Related business** - Charities have successfully used related business models in limited circumstances to fund their missions. Such businesses are sometimes called “social enterprises”. An approach that allows charities to carry on any business as long as the profits are applied toward the charity’s registered purposes (a “destination of funds” approach) would further enhance the ability of charities to obtain financial security.

   **Collaboration rules** - Charities and NPOs also work through hybrid structures in which a charity establishes or collaborates with a separate for-profit entity to carry on social enterprise activities that could not be conducted directly. Clarity is needed around the rules that govern these collaborations.

3. **Hybrid Organizations/Structures** – An untested vehicle that locks assets for the public purpose. Are they necessary? Will they assist?

4. **Modernization** – Each of the above areas and suggestions for change could be addressed in the modernization project. There is an urgent need to modernize and overhaul the regulatory system for charities and non-profit organizations. The current
legislative framework is unwieldy for charities and basically non-existent for tax-exempt non-profit organizations. However, modernization should only occur after embarking on a significant study to consider options for structural change applicable across all sectors and to reflect the 21st century economic environment and communities in Canada today. Principles that should guide that review include transparency, accountability, maintaining trust in the charitable sector, and ensuring the policy takes a charitable beneficiary or social purpose first approach.

**Background**

The current system revolves around the assumption that tax-assisted donations are central to a charity’s existence. A charity has to be registered in order to issue tax receipts for donations, or to receive funding from other organizations that have received tax assisted donations. With a few exceptions (i.e. qualified donees) the system operates as a closed environment so that tax assistance finds its way to deserving recipients of charity, and does not find its way to other entities whose characteristics and operations do not warrant state support.

However, it has become increasingly obvious over the past half-century (a) that donations are not a sufficient source of funding, (b) top-down relief programs are not always the best approach to tackling issues such as poverty, social rehabilitation, research, or humanitarian relief in third-world countries and (c) there is a growing interest in pursuits that combine a social and profit purpose. The silos established decades ago are breaking down. Because of the current system, and arguably in spite of it, registered charities have had to resort to creative strategies both to generate sufficient funds and to tackle social issues effectively. They too often find their operations hampered by the existing rules.

Similarly, tax exempt non-profit organizations with community objectives struggle because of a lack of clear regulation and conflicting administrative policies.

**Social Finance**

Charities and non-profits need access to all forms and sources of capital – including earned income, loans and investments – since donations and grants together cannot meet all their financing needs. One source of financing for social purpose activities is endowed dollars held in charitable foundations. Generally, assets of charitable foundations are invested in listed securities or other forms of public market securities. Charitable funders are often willing to consider investing in social purpose activities either in charities (through loans, for example) or in social enterprises operated by businesses and non-profits. Such investments, however, are often characterized by higher risk and lower returns than public market investments, which can create compliance risk (or at least uncertainty) for foundations under the current tax rules. Easing these rules to facilitate charitable foundations investing in such social purpose activities and social enterprises, particularly where these activities are conducted by a non-charity, could unlock charitable dollars to support a broad range of socially beneficial activities while still generating returns to the investor foundation for further reinvestment and granting – a virtuous cycle.

Recently, the Social Innovation and Social Finance Strategy Co-Creation Steering Group (the “Steering Group”) reported to Minister Duclos. The Steering Group recommended that “the government should make it easier for registered charities to innovate in collaboration with non-qualified donees, including non-profits, businesses, and social innovators.”
Such a change could enhance the ability of registered charities to invest in social purpose activities consistent with their missions. One change which could assist would be to amend the Income Tax Act to enable registered charities to use their dollars to support programs run by non-qualified donees provided they adopt an appropriate expenditure responsibility regime as a mechanism to ensure accountability and that the charity’s resources are being used in furtherance of its purposes. This modernization of the rules relating to direction and control when carrying out activities with non-qualified donees will enable charities to work more closely with beneficiary groups and open up the rules pertaining to program related investments, which affect charities’ ability to invest for both economic and social returns.

Additionally, tax or other incentives don’t exist to attract capital from other sources to such social purpose investments. The costs of structuring such investments, accessing the capital, and scaling the projects often result in the odds being stacked against projects before they are off the ground. Consideration could be given to special tax incentives or regulatory measures to incent additional capital investment in social purpose activities. The Standing Senate Committee on Social Affairs, Science and Technology in its 2018 report entitled The Federal Role in a Social Finance Fund, called on the government to address the barriers to creating a social finance market by creating a social finance fund. The Steering Group also adopted the Creation of a Social Finance Fund as their sixth recommendation.

The development of a social finance fund along with changes to the regulatory regime that would enable charitable funders who wish to provide capital in the form of loans and investments to social purpose non-qualified donees without risk of loss of registered status and the establishment of clear guidelines around program related investments (below market investments made in non-qualified donees) would greatly assist in growing the social finance field in Canada.

Social Enterprise

The current rules permit charities to pursue a “related business”, being a “business” that is related to the (charitable) purpose of the charity and that is subordinate to those purposes. The longstanding concept of related business falls into the category of revenue-generating activity that is now commonly referred to as “social enterprise”. The term “social enterprise” is broader, however, and may encompass social purpose revenue generating activities carried out not just by a registered charity, but also by a for-profit or non-profit that has a social purpose.

Regulatory change that would facilitate revenue generation by registered charities to support their social programming could consist of permitting charities to rely on the “destination of funds” test. This would enable charities to use their assets to generate revenues even if the activity cannot be directly related to their purpose, provided those revenues are used in the furtherance of their charitable purposes.

Otherwise, the sector would benefit from clarity and modernization around the rules for when a business activity that directly furthers a charitable purpose will be considered related. Technology has significantly changed how revenue generation occurs and the ability today of registered charities to develop and innovate programs that could in turn generate revenues has resulted in opportunities for charities to generate revenues in ways that have never been contemplated by the current administrative guidance, CPS-019. For example, a youth computer
training program that includes website development could generate revenues by offering web design for a fee to support the programs.

As noted, a social enterprise can also be pursued by non-profits and taxable entities. Registered charities often consider establishing a second corporate entity to pursue revenue generation that may not otherwise appear to qualify under the related business rules. In spite of the difficulties and legal challenges in currently establishing such structures, they are sometimes appropriate for non-charity reasons such as sheltering risk or protection of assets. Clarifying the rules around the relationship between charities and controlled taxable subsidiaries would better facilitate the funding of the sector through controlled social enterprises.

Public benefit non-profit organizations typically exempted from tax under s.149(1)(l) of the Act are seriously constrained by the provisions of the *Income Tax Act* in their pursuit of surpluses and this inhibits their qualification as social enterprises. This is the case notwithstanding that such surpluses are used to fund the non-profit activity. The lack of any form of regulation or transparency for tax exempt non-profit organizations undermines the ability of Canadians to use this corporate form for public benefit activities. Regulatory change could assist with the proper operation of all forms of enterprising activity. Any change must include provision for transparency and accountability for such organizations as to date that does not exist.

**Hybrid Organizations**

Various jurisdictions have enacted statutory frameworks which permit the creation of corporate forms that are based on a for profit share capital corporate model (a business corporation) but also contemplate a lock on assets and revenues that will be directed to a social purpose which is identified in the incorporation documents. These hybrid organizations arose out of a desire to be able to attract investment in the form of equity capital in the social purpose revenue generating activity. Such entities are treated as for profit businesses for income tax purposes and there are no federal tax incentives to promote investment.

Hybrid organizations have not been widely adopted to date in Canada. Some question the need for these structures, particularly if changes are made to enable greater social enterprise activity in registered charities and non-profit organizations. Others believe that with the appropriate tax benefits, significant investments could be made through such organizations in the future. Any work on modernization and regulatory change should consider, and if determined appropriate, address the role of hybrid organizations.

**A Modern Regulatory Framework for the Charitable Sector**

In its report delivered to the Minister of National Revenue at the end of March 2017, the Consultation Panel on Political Activities called on the Government to modernize the legislative framework governing the charitable sector. In its rationale for this recommendation the Panel stated:

“The present legislative framework is based on antiquated law, and does not reflect the reality of charities in Canada today or the expectations of their stakeholders. The formative pieces of legislation that have established the current regime were created in the mid to late 20th century, and have not kept pace with the rate or nature of social change. The current law and CRA’s interpretation of it, present barriers to what charities can do and should be doing.”
The proposed modernization of the legislative framework for charities would appropriately recognize the critical role played by charities in Canadian society, facilitate their involvement in public policy dialogue and development, better enable the provision of much-needed services to Canadians and others around the world, and recognize their contribution to the Canadian economy.\(^1\)

The Social Innovation and Social Finance Strategy Co-Creation Steering Group (of which a Canadian foundation leader was a member) reported at the end of August 2018 to Minister Duclos.\(^2\)

One of its recommendations was “the Government move from a compliance-based approach to regulating registered charities and non-profit organizations to one that is enabling and adaptive, so that organizations are able to innovate more readily. This new approach will require a paradigm shift, where the Government recognizes charities and non-profits as partners in achieving common objectives and acknowledges that they create value beyond the cost of the tax benefits they receive. Rather than treat charities and non-profits as competitors with the private sector, the Government should embrace the sector as part of an ecosystem of players that together create social and economic value for Canadians.”

The rules in the *Income Tax Act* need to be modernized to operate more effectively to permit registered charities and other public benefit organizations to achieve their objectives in a way that is financially sustainable. The new rules need to recognize the evolution of the sector, the Canadian economy, new forms of investing and the way registered charities and public benefit organizations will have to work in the future. To achieve this, the new rules should not merge categories of organizations but rather should provide clear rules applicable to each category and provide rules that require organizations which work with each other to do so in a transparent and accountable way. These rules will contain appropriate measures to ensure that tax-assisted dollars and the revenues generated from those dollars are not inappropriately being diverted into private pockets (e.g., those of individuals or for-profit businesses) and that the playing field for all in the economy is level that no one form of entity (taxable, tax exempt or charity) is favoured in a way that could be considered to contribute to unfair competition within the system. Appropriate anti-tax evasion measures should also be considered.

Such an overhaul, while badly needed, should be preceded by considered study and consultation. The result could then be a comprehensive modernized regime that encompasses registered charities, tax exempt non-profit organizations, other categories of qualified donees and considers their overlap and interconnection (which will continue to grow in the future) with taxable enterprises. The overarching principle guiding the study should be that changes should be tested against a priority of preserving the vital role charities and public benefit organizations play in serving their clients and our communities.

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Miller Thomson's Social Impact Group

Miller Thomson's Social Impact Group is the largest national team of legal experts in Canada dedicated to helping charities, non-profit organizations and social enterprises meet their legal needs and accelerate their social impact. Clients from philanthropic foundations to active charities to member-based associations depend on us to deliver strategies that propel them ahead of changing regulations, effectively address general legal issues, and design innovative structures that unlock sustainable new sources of revenue. The Social Impact Group offers unmatched experience and expertise across Canada’s voluntary sector and beyond. Our forward-looking advice helps clients anticipate and address all manner of legal issues and position themselves for long-term impact and success.