More Reflections on Legal Structures for Community Enterprise

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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*.[1] 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."[2]

This recommendation drew from submissions made to the Committee by several of Canada's third sector leaders, including Tim Draimin, Executive Director, Social Innovation Generation (SiG) National, and others. They argue that Canada should build upon the recent advances in the UK and the US that allow for the incorporation of new legal structures intended to help social or community enterprises to flourish.

I agree with this recommendation, and have argued elsewhere that the adoption of a new hybrid legal structure would help Canada's law keep pace with changes in the nature of community and commerce, and would bolster social or community enterprise.[3] By "hybrid," I mean that it combines elements of private benefit fundamental to the business corporation structure, with elements of public or community benefit associated with non-profit organizations and charities.

This paper revisits the UK innovation (detail about the US variation is available in the earlier paper linked below) and examines how a similar new Canadian legal structure would fit in relation to the existing options: co-operatives, non-profit organizations, and business corporations. It also briefly notes new legislative developments unfolding in some American states.

Social or Community Enterprise:

There is no single definition of social enterprise, but this one is good:

[1] www2.parl.gc.ca/HousePublications/Publication.aspx?DocId=4304866&Language=E&Mode=1&Parl=40&Ses=2
[2] www2.parl.gc.ca/HousePublications/Publication.aspx?DocId=4304866&Mode=1&Parl=40&Ses=2&Language=E&File=447
[3] www.centreforsocialenterprise.com/f/Legislative_Innovations_and_Social_Enterprise_Structural_Lessons_for_Canada_Feb_2009.pdf

> A social enterprise is an organization or venture that achieves its primary social or environmental mission using business methods. The social needs addressed by social enterprises and the business models they use are as diverse as human ingenuity. Social enterprises build a more just, sustainable world by applying market-based strategies to today's social problems.[4]

I prefer the term "community enterprise," and use it interchangeably here with "social enterprise".

A. The UK Innovation

In 2005, new legislation and regulations were adopted in the United Kingdom that enable the creation of a new type of company called Community Interest Companies, or "CICs". By March 31st, 2010, approximately 3,500 CICs had been established in the UK[5] to advance a wide range of community enterprises.

They have these fundamental features:

1. CICs are established to trade (goods or services) for the community good. To qualify for CIC status, the company must submit to the CIC Regulator a "community interest statement" that includes:

    a. certification that it has been formed to serve the community rather than to make private profits;

    b. a declaration that it will not engage in political activity;

    c. a description of its activities and how they will benefit the community; and

    d. a description of how surpluses will be used.

   Subsequent annual reports are required, in order to confirm that the CIC continues to meet the community interest requirement. These reports are available for public review, ensuring a high level of transparency.

2. CICs may issue shares in order to raise capital. But unlike a traditional business corporation, the dividends that can be paid by CICs on these shares are controlled by a cap on returns set by the Regulator. Likewise, caps apply to interest paid out.[6]

3. CICs are subject to an "asset lock", which means that the assets must be permanently retained by the CICs for community benefit, or transferred to another CIC subject to an asset lock, or to a charity.

4. CICs are subject to fewer regulations than charities, and may be established for purposes that do not meet the legal test of charity. But CICs do not enjoy the same favourable tax treatment that charities receive. They are taxed in the same manner as other businesses.

In my view, the most attractive feature of the CIC is that it encourages the combination of private investment capital with activities that benefit community. In Canada and elsewhere, limited access to risk and patient capital is a primary obstacle to social enterprise projects, such as community economic development or environmental initiatives. CICs have the legal capacity, like business corporations, to raise funds in exchange for shares. This enables the investment of private wealth in community projects – a very powerful combination that has not yet been adequately tapped in Canada.

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[4] This is from the Washington D.C.-based Social Enterprise Alliance.
[5] www.cicregulator.gov.uk/coSearch/companyList.shtml
[6] www.cicregulator.gov.uk/Notices-%20Dividend%20&%20Interest%20Cap%20v01.pdf

Other appealing features of the CIC are the legitimacy and profile that they bring to community enterprise, and the additional choice that they provide for community entrepreneurs.

B. Co-operatives and CICs

A question that has arisen in my discussions of the potential for Canada to adopt a structure similar to the CIC is whether it is necessary, given our existing federal and provincial co-operative legislation and regulatory regimes.

Co-ops are vitally important to Canada's economy and communities. There are over 9,000 co-operatives serving over 17 million members in virtually every field of endeavour.[7] The Canadian Co-operative Association summarizes the key differences between business corporations and co-operatives this way:

> "**A Different Purpose:** The primary purpose of co-operatives and credit unions is to meet the common needs of their members, whereas the primary purpose of most investor-owned businesses is to maximize profit for shareholders.
>
> **A Different Control Structure:** Co-operatives and credit unions use the one-member / one-vote system, not the one-vote-per-share system used by most businesses. This helps the co-operative or credit union serve the common need rather than the individual need, and is a way to ensure that people, not capital, control the organization.
>
> **Different Allocation of Profit:** Co-operatives and credit unions share profits among their member-owners on the basis of how much they use the co-op, not on how many shares they hold. Co-operatives and credit unions also tend to invest their profits in improving service to members and promoting the well-being of their communities."[8]

Co-operatives are guided by these key principles:

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

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

[7] Canadian Co-operative Association www.coopscanada.coop/en/about_co-operative/Co-op-Facts-and-Figures
[8] www.coopscanada.coop/en/about_co-operative/How-are-Co-operatives-Different-

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

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

Within this critical mass of members, there must be a core group of committed and able members willing to do the hard work needed to make the co-operative enterprise work. In situations in which there is a critical mass of members and a core of committed and able members, 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.

This space is where I believe a CIC structure would fit well as a new option for community enterprise in Canada. It would serve as an attractive option to a single entrepreneur with a plan for a community enterprise. It is an alternative to the business corporation structure that ensures – through the community benefit test, a cap on returns, and the asset lock – that the community interest remains paramount and assured. With the business corporation model, private benefit is paramount, and public benefit is optional at the discretion of the shareholders.

A CIC structure may also be attractive to a group of individuals or organizations with a shared vision for a new community project or program, but with no interest in a relationship based on membership. Some may plan to run the enterprise, others may be willing to serve on a board of directors or advise, and some may simply wish to invest. A CIC structure could provide more choices and flexibility in terms of these relationships than a co-operative, which has clear legislative parameters that codify the co-operative model and governance mechanisms.

The appearance of a Canadian CIC option should not undermine the co-operative movement. In those circumstances where a membership-based structure is the best choice, new co-operatives will be created.

C. Non-profit Organizations and Business Activities

In my experience, it is common practice for social or community enterprises to be structured as "non-profit organizations."

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.

Registered charities must meet rigorous annual reporting requirements and comply with a range of common law, legislative, and administrative policies, which limit, direct, and audit their activities and create high standards of conduct and transparency. This is primarily because charities have the privilege of issuing tax receipts to donors. These receipts have a substantial impact on the public purse, and it is essential that appropriate standards and government monitoring be in place to ensure the integrity of the charitable registration system.

In contrast, non-profit organizations occupy space that is largely off the radar from a regulatory perspective, and they have to date enjoyed much greater latitude than charities. Because they do not issue tax receipts and do not pay income tax, there is little incentive for government to devote its scarce resources to monitoring them. There is no register of non-profit organizations in Canada, nor is there an equivalent to the Charities Directorate at the Canada Revenue Agency dedicated to overseeing non-profit organizations. Indeed, we do not know with certainty how many non-profit organizations exist in Canada.

The law concerning business activities or community enterprise by non-profit organizations has shortcomings. It is neither complete nor clear.

Incorporation Legislation

Most non-profit organizations are incorporated under provincial legislation as societies or corporations without share capital, or sometimes as co-ops without the ability to pay dividends. Others are incorporated under Part II of the *Canada Corporations Act*, which will soon be replaced by the *Canada Not-for-Profit Corporations Act*.

It is important to note that these acts are not identical when it comes to businesses activities.

For example, in Nova Scotia, the *Societies Act* states:

> **3 (1)** A society may be incorporated under this Act to promote any benevolent, philanthropic, patriotic, religious, charitable, artistic, literary, educational, social, professional, recreational or sporting or any other useful object, but not for the purpose of carrying on any trade, industry or business.

The inclusion of the word "business" is interpreted by the corporate registry as allowing no business activity, unless it involves the sale of at least 90% donated goods or is composed of a 90% volunteer workforce. This narrowly restricts enterprises operating within societies.

But in BC, the *Society Act* expressly builds "profit" into the equation. It states that a society must not be created for "the purpose of carrying on a business, trade, industry or profession for profit or gain" (section 2(1)(f)). It then goes on to state that "carrying on a business, trade, industry or profession as an incident to the purposes of a society is not prohibited, but a society must not distribute any gain, profit or dividend or

otherwise dispose of its assets to a member of the society without receiving full and valuable consideration..."

This gives societies incorporated under the BC *Act* scope to engage in "incidental" business activities.

The federal incorporation legislation (current and pending) does not provide explicit guidance on the question of business activities, while the legislation in the other provinces is a patchwork and in a state of revision. It is prudent to review the applicable incorporation legislation before starting business activities in a society or corporation without share capital, in order to ensure legal capacity to engage in business activities.

The Canada Revenue Agency's Position

Whether an entity qualifies as a non-profit organization and enjoys tax exempt status is a decision for the Canada Revenue Agency, which administers the federal *Income Tax Act*. It is possible for an entity to be incorporated federally or provincially as a society or corporation without share capital, but to be deemed a taxable entity based on the activities of that entity.

The key legislative provisions are summarized above. To provide interpretive guidance, the CRA published IT 496R[9] in 2001. This policy document briefly addresses permissible business activities by non-profit organizations, and includes this passage:

> "It will be a question of fact to be determined with regard to the particular circumstances as to whether an association is carrying on a trade or business and if so, whether it will result in a finding that an association is not operated exclusively for non-profit purposes. Some characteristics that might indicate that an activity is a trade or business are as follows:
>
> (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.
>
> Generally, the carrying on of a trade or business directly attributable to, or connected with, pursuing the non-profit goals and activities of an association will not cause it to be considered to be operated for profit purposes." (underline added)

IT 496R goes on to state that non-profit organizations may accumulate excess funds to meet future needs, but that surpluses must not be excessive.

On November 5, 2009, the Income Tax Rulings Directorate of the CRA issued an opinion letter[10] in response to several questions, including:

[9] www.cra-arc.gc.ca/E/pub/tp/it496r/it496r-e.html
[10] The text of the opinion letter is reproduced as an appendix.

(i) Can an organization that qualifies for an exemption from tax under paragraph 149(1)(l) of the Act compete against taxable entities?

(ii) Can an organization earn a profit and continue to be exempt from tax under paragraph 149(1)(l) of the Act? Can an organization intentionally earn a profit, and still be exempt from tax under 149(1)(l), as long as that profit is used solely for the purpose of supporting its objectives?

(iii) Is it possible for an organization to incorporate under Part III of the Ontario *Corporations Act*, but not qualify for the exemption from tax provided under paragraph 149(1)(l) of the Act?

In answering these questions, the CRA official who wrote the opinion advanced a position that represents a more restrictive approach to non-profit organizations and business activities than that taken in IT 496R. The opinion letter states:

> "...where an organization intends, at any time, to earn a profit, it will not be exempt from tax under paragraph 149(1)(l) even if it expects to use or actually uses that profit to support its not-for-profit objectives."

It goes on to state that non-profit organizations can earn a profit, but that:

> "the profit should generally be unanticipated and incidental to the purpose or purposes of the organization. For example, an organization might budget with the intention of not earning a profit, but ultimately find itself with a profit because of expenses that were less than anticipated or that were reasonably expected but not incurred."

This approach could prove to be problematic for non-profit organizations that engage in business activities to generate income in order to cross-subsidize other community, charitable, or social activities. I expect that many non-profit organizations in Canada do intentionally earn profits from business activities and use those profits to support their "not-for-profit objectives", on the assumption that if there is no overall profit, then non-profit status can be maintained. With this more restrictive CRA view of business activity and profit, those entities would therefore be off-side with this CRA interpretation, and could potentially lose their non-profit status, exposing themselves to taxation on those profits.

The November 5, 2009 opinion letter includes this qualification: "Please note that the following document, although believed to be correct at the time of issue, may not represent the current position of the CRA." It remains to be seen whether it will become the official position of the CRA; whether IT 496R will prevail or perhaps be modified to reflect this more restrictive approach; or whether the CRA will take any enforcement steps on this point. Enforcement would no doubt result in appeals to the courts, and judicial clarification of the issue, or ultimately to clarification by legislative amendment.

In the meantime, people interested in community enterprise must be careful not to assume that a non-profit organization is the ideal vehicle for that work. The freedom to cross-subsidize internally with profits from business activities is in doubt.

D. **Business Corporations**

Community enterprises can adopt the legal form of business corporations established under existing incorporation legislation. Indeed, this is the structure recommended by the Canada Revenue Agency for registered charities that have engaged in or are considering an "unrelated" business activity.[11]

The essential objective recognised by corporate law and theory is the maximization of shareholder value. It is possible for business corporations to adopt other objectives, such as community or environmental benefit, and for corporate shareholders to enshrine these objectives or values in formal incorporation documents. In the United States, the term "B Corporation" is applied to a voluntary certification system created by a non-profit organization called B Lab, which describes the term this way:

> "B Corporations are a new type of corporation which uses the power of business to solve social and environmental problems. B Corporations are unlike traditional responsible businesses because they:
>
> - Meet comprehensive and transparent social and environmental performance standards.
> - Institutionalize stakeholder interests.
> - Build collective voice through the power of a unifying brand." [12]

This approach is an encouraging variation on the traditional business corporation, indicating momentum for more than just maximizing shareholder value. Some Canadian corporations have now been certified by B Lab as B Corporations. But this approach has some shortcomings. First, it is purely voluntary, and shareholders can ultimately revise incorporation documents to reassert shareholder primacy. Second, the certification system has no formal regulatory or enforcement authority and no legislative foundation. And third, it does not represent formal recognition by the state of the validity and importance of community enterprise.

It appears that these shortcomings have been noted by U.S. legislators. In April 2010, the State of Maryland passed legislation officially enabling and legitimizing "Benefit Corporations."

Key features of the new law are:

- Explicit recognition that public benefit purposes (e.g. positive environmental or community impacts) may be adopted by corporations;
- An obligation on directors to pursue those purposes and consider the interests of stakeholders (employees, community, etc.);
- Confirmation that the maximization of shareholder value is not the dominant duty of directors, and legal protection for directors who pursue public benefits;
- A requirement that Benefit Corporations publish annual Benefit Reports that document performance in achieving their public benefit purposes; and
- A 2/3 shareholder vote requirement for changes to the control, purpose, or structure of a Benefit Corporation.[13]

Other states are reported to be considering similar legislative initiatives.

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[11] See "What is a Related Business?" Reference Number CPS - 019 www.cra-arc.gc.ca/tx/chrts/plcy/cps/cps-019-eng.html
[12] See www.bcorporation.net/about
[13] See www.csrwire.com/press/press_release/29332-Maryland-First-State-in-Union-to-Pass-Benefit-Corporation-Legislation?tracking_source=rss

In my view, the volunteer B Corporation approach should be viewed as complementary to a new Canadian legal structure for social enterprise, but not a substitute for it. The legislative approach taken in Maryland looks to address the shortcomings of the voluntary approach, at least in part, and may prove to be a very substantial development. Indeed, this progress strengthens the assertion that legislative action to enable and encourage new legal structures for community entities has merit.

E. **Legal Structure and Tax Treatment**

Much of the policy discussion involving social or community enterprise addresses questions of tax treatment. The basic question is whether community enterprises should receive favourable income tax treatment vis-à-vis non-profit organizations and business corporations. In the UK, CICs are taxed at the same rate as businesses. In my view, a marginally lower rate of income tax for CICs is worth consideration.

A case can also be made for a tax credit system like Nova Scotia's Equity Tax Credit. This is a provincially operated personal tax credit of 35 per cent that encourages equity investments in qualifying corporations, co-operatives, and community economic development initiatives. It is a model that could be adopted by the federal government and other provinces.

Such favourable income or investment tax treatment should be available for organizations that meet a community benefit test defined by Parliament or provincial legislatures. CICs should qualify because community benefit is a prerequisite for incorporation in that form. Co-operatives and corporations that can establish that they meet the community benefit test should also be eligible to qualify for this favourable tax treatment. Legal structure should not be the sole determinant in this regard. In this way, the legal structure best suited for the enterprise can be chosen, and existing co-operatives and business corporations engaging in community enterprise will not be disadvantaged from a tax perspective.

F. **Conclusions**

In my opinion, the time is right for a Canadian version of the CIC. It will help modernize Canada's legal and regulatory framework regarding social or community enterprise, and it will fill a gap between business corporations, co-operatives, non-profit organizations, and charities. This new legal structure could be modeled closely on the UK approach, or it could draw on the Benefit Corporation model legislation recently adopted in Maryland, or could combine attributes of both. Such a new structure will not displace the existing options, but will give more choice to entrepreneurs and organizations with a desire to devote their creativity to community benefit.

This could be achieved through amendments that build upon existing corporate legislation or through the creation of new stand-alone enabling legislation at the federal or provincial level. The first Canadian legislation of this kind will be a significant and welcome step forward.

Appendix: CRA Opinion Letter - November 5, 2009

Can a Canadian non-profit under 149(1)(l) earn a profit. Does it matter if the profit is intentional and/or will be used to further the organization's purposes?

LANGIND E
DOCNUM 2009-0337311E5
AUTHOR Zannese, Lisa
DESCKEY 25
RATEKEY 2
REFDATE 091105
SUBJECT 149(1)(l) Organizations
SECTION 149(1)(l)

Please note that the following document, although believed to be correct at the time of issue, may not represent the current position of the CRA.

Prenez note que ce document, bien qu'exact au moment émis, peut ne pas représenter la position actuelle de l'ARC.

PRINCIPAL ISSUES: (i) Can a 149(1)(l) organization earn a profit? (ii) If the profit is intentional but used to fund the activities of the organization will the organization qualify for the 149(1)(l) exemption from tax? (iii) Can a 149(1)(l) organization engage in commercial activities? (iv) Does the CRA maintain a list of organizations that qualify for the exemption provided by 149(1)(l)?

POSITION: (i) Yes, but only if incidental and generally unanticipated. (ii) No (iii) Yes (iv) No

REASONS: (i) To qualify for the exemption an organization cannot be organized or operated with a purpose of earning a profit. (ii) It does not matter what the profit is used for, a 149(1)(l) organization cannot have any profit earning purpose. (iii) Paragraph 149(1)(l) does not restrict an organization to any particular activities, other than requiring activities not to be undertaken for profit. (iv) The CRA does not maintain a list of 149(1)(l) organizations as these organizations are not required to register with CRA.

XXXXXXXXXX 2009-033731
L. Zannese
(613) 957-2747

November 5, 2009

Dear XXXXXXXXXX :

Re: Tax Exemption-149(1)(l)

We are writing in response to your emails of August 18 and September 17, 2009, in which you asked for our views regarding the tax exemption provided by paragraph 149(1)(l) of the Income Tax Act (the "Act") . We also acknowledge our telephone conversations regarding this issue (Erskine/XXXXXXXXXX).

Specifically, you have asked the following questions:

(i) Can an organization that qualifies for an exemption from tax under paragraph 149(1)(l) of the Act compete against taxable entities?

(ii) Can an organization earn a profit and continue to be exempt from tax under paragraph 149(1)(l) of the Act? Can an organization intentionally earn a profit, and still be exempt from tax under 149(1)(l), as long as that profit is used solely for the purpose of supporting its objectives?

(iii) Is it possible for an organization to incorporate under Part III of the Ontario Corporations Act, but not qualify for the exemption from tax provided under paragraph 149(1)(l) of the Act?

(iv) Does the Canada Revenue Agency ("CRA") maintain a list of organizations that qualify as non-profit organizations for purposes of provincial legislation, but do not qualify for the tax exemption provided under paragraph 149(1)(l) of the Act?

(v) The recent Tax Court of Canada decision, BBM Canada v. The Queen, 2008 DTC 4129 ("BBM") concluded that an entity described in paragraph 149(1)(l) of the Act may conduct commercial activity but must conduct this activity at cost. If the XXXXXXXXXX provided a commercial procurement contract to an organization, and the organization generated a profit from this activity, would the organization be able to qualify for the tax exemption provided under paragraph 149(1)(l) of the Act?

If the above questions relate to a specific taxpayer and either a completed transaction or an ongoing situation, you should submit all relevant facts and documentation to the appropriate Tax Services Office ("TSO") for their views. A list of TSOs is available on the "Contact Us" page of the CRA website, http://www.cra-arc.gc.ca. Although we cannot comment on any specific situation, we are prepared to provide the following general comments, which may be of assistance.

Our Comments

(i) Paragraph 149(1)(l) of the Act.

Paragraph 149(1)(l) of the Act provides an exemption from tax for the income of organizations that meet all of the conditions set out in that provision. Among other criteria, the organization is required to be organized and operated for "any other purpose except profit"; consequently, it is common to refer to organizations qualifying for this tax exemption as "non-profit organizations". However, the term "non-profit organization" does not have a specific meaning for income tax purposes-the Act does not define or use the term "non-profit organization". For purposes of this letter we will refer to an organization that qualifies for the tax exemption provided by paragraph 149(1)(l) as a "149(1)(l) entity".

Paragraph 149(1)(l) of the Act provides an exemption from income tax for the income of

"...a club, society or association that, in the opinion of the Minister, was not a charity within the meaning assigned by subsection 149.1(1) and that was organized and operated exclusively for social welfare, civic improvement, pleasure or recreation or for any other purpose except profit, no part of the income of which was payable to, or was otherwise available for the personal benefit of, any proprietor, member or shareholder thereof unless the proprietor, member or shareholder was a club, society or association the primary purpose and function of which was the promotion of amateur athletics in Canada;"

Very generally, then, in order for an organization to be a 149(1)(l) entity, the organization must not be a charity, must be organized and operated for a purpose other than profit, and its income cannot be payable to or made available for the benefit of its members.

You have asked whether an organization can compete against taxable entities and still qualify for the exemption provided by paragraph 149(1)(l) of the Act. The wording of paragraph 149(1)(l) does not restrict an organization from undertaking any particular type of activity, including commercial activity. This issue was most recently reviewed by the courts in BBM, 1 in which the Tax Court of Canada commented:

"While these are very strict and rigid requirements, and potentially permit a very broad review or inquiry into an organization's purposes, the analysis can be considerably abbreviated by the fact that the statutory language does not mandate a qualifying purpose but permits the organization to have any purpose or purposes other than the one disqualifying purpose of profit."

Consequently, an organization can compete against taxable entities and still be exempt from tax under paragraph 149(1)(l) of the Act.

(ii) 149(1)(l) Entity-Earning, Retaining and Using a Profit

You have asked whether a 149(1)(l) entity can earn a profit, and whether the answer to this question depends on how the entity uses this profit. Specifically, you would like to know if a 149(1)(l) entity can intentionally earn a profit as long as the profit is used to support the objectives of the 149(1)(l) entity.

Paragraph 149(1)(l) of the Act requires that an organization be organized and operated "exclusively" for "any other purpose except profit" in order to be exempt from tax under that provision. In our view, the use of the word "exclusively" indicates that while an organization may have many purposes, none of those purposes may be to earn a profit. Thus, where an organization intends, at any time, to earn a profit, it will not be exempt from tax under paragraph 149(1)(l) even if it expects to use or actually uses that profit to support its not-for-profit objectives.

The CRA accepts that a 149(1)(l) entity can earn a profit; otherwise, the tax exemption provided would be unnecessary. Earning a profit, in and of itself, does not prevent an organization from being a 149(1)(l) entity. However, the profit should generally be unanticipated and incidental to the purpose or purposes of the organization. For example, an organization might budget with the intention of not earning a profit, but ultimately find itself with a profit because of expenses that were less than anticipated or that were reasonably expected but not actually incurred. If the original budget was reasonable, the profit earned would not, in and of itself, cause the organization to cease to be a 149(1)(l) entity.

The Supreme Court of Canada commented on the issue of a purported 149(1)(l) entity earning a profit in Woodward's Pension Funds v. The Queen, 62 DTC 1002 ("Woodward's"):

"... it is true that ... the appellant was organized for the stated object and purpose of assisting in the provision of funds for pensions to be paid to employees and ex-employees of the stores. Nevertheless, this last-named purpose could not be achieved without the share sale plan which was designed to make a profit to enable the payments to be made to the pension trustees. ... The appellant has entirely failed to establish that it was organized and operated exclusively for a purpose other than profit and the findings of the learned President that it was both organized and operated for a profitable purpose are unassailable."

The Tax Court of Canada followed the Woodward's decision in Tourbec (1979) Inc. v. M.N.R, 88 DTC 1442 ("Tourbec"). Tourbec involved an organization that sponsored travel for young people through the operation of a travel agency. On the issue of whether the organization operated for a purpose other than profit the court found:

"What effectively happened was that Tourbec used the revenues that it received from its regular sales, that is the sales to the general public, to subsidize to a certain extent certain services that were reserved exclusively to its customers who were students and young people."

"Given the facts, I cannot accept the appellant's submissions to the effect that it was an organization whose sole purpose was among those referred to in section 149(1)(l) of the Act. The philanthropic aspect of its operations was only incidental to its primary purpose which was to carry on a travel agency business. That incidental aspect could not have been achieved unless it had been able to make profits from its primary business."

While the reference to a "primary purpose" in Tourbec suggests that a secondary, profit-making purpose might be acceptable for a 149(1)(l) entity, we are of the view that the decision in Tourbec means that, for paragraph 149(1)(l) of the Act to apply, an organization's "sole purpose" (or only purposes) must be something other than earning a profit. 2 In our opinion, the decisions in Woodward's and Tourbec support the position that where an organization would be unable to undertake its not-for-profit activities but for its profitable activities, the organization cannot be a 149(1)(l) entity because it has a profit purpose.

We acknowledge that a 149(1)(l) entity may earn a profit as long as that profit is generally unanticipated and incidental to carrying out the entity's exclusively not-for-profit purposes: The Gull Bay Development Corporation v. Her Majesty the Queen, 84 DTC 6040 (FCTD) ("Gull Bay"). In Gull Bay the court found that the corporate entity in question was "operated "exclusively" for the purpose set out in section 149(1)(l) pursuant to its charter, even though it may raise funds for this purpose by its commercial lumbering enterprise."

We note that the situation reviewed by the court in Gull Bay was very unusual and that the decision of the court turned greatly on the particular facts of that case, especially with respect to the finding that the profits were strictly incidental to the not-for-profit objectives. Also, the decision in Gull Bay must be read in light of the court's view that the corporation might be a "charitable corporation" and in light of subsequent court decisions such as Tourbec and BBM.

It is always a question of fact whether an organization is operating for the purpose of earning a profit. A "profit" is generally considered to be the (positive) difference between an organization's revenue and the expenses incurred to earn that revenue: see the review of the meaning of "profit" in BBM. We are of the view that in determining the expenses incurred by an organization to earn revenue, it is appropriate to take into account depreciation of capital assets as well as ongoing current expenses. However, it is not appropriate to take into account the anticipated cost of future capital projects, because that cost cannot, by its nature, be an expense incurred to earn the current revenue. Thus, in considering whether an entity has a profit purpose, regard must be had to whether the entity is intentionally generating profit in order to finance future capital projects.

In our view, if a 149(1)(l) entity could intentionally earn a profit to finance future capital projects on the basis that this constituted operating at cost and therefore did not indicate a profit purpose, then any business where the members did not require income distributions could be organized and operated as a 149(1)(l) entity and accumulate wealth on a tax-free basis. In this situation, while members could not access the business' income immediately, the value of the organization, and consequently the value of the membership interests, would clearly increase. It would not be difficult to maintain that there was no profit purpose, as the courts have pointed out that where a business provides services to its members at cost, "*t would be difficult to impute a profit purpose" (BBM). Consequently, it is our view that in determining whether there is a profit purpose, "profit" should be given its ordinary commercial meaning, which does not include deductions for amounts related to future capital projects.*

There are instances when a 149(1)(l) entity may have funds on hand in excess of its immediate operating requirements. While retaining excess funds may be evidence that an organization is operating with a profit purpose, generally, this will not in and of itself result in the organization failing to qualify as a 149(1)(l) entity. For example, in our view, a 149(1)(l) entity may accumulate members' contributions over a period of years in order to finance a planned, future capital project. Also, we acknowledge that the entity may earn reasonable investment income with respect to such accumulated funds, even though such income might otherwise be considered anticipated profit. However, if the excess funds were collected for the purpose of earning investment income rather than for the

purpose of funding a specific capital project, then this would be a profit purpose and the organization would no longer be a 149(1)(l) entity.

(iii) Provincial Legislation and the Income Tax Act

Several of the provinces have enacted legislation that sets out how an organization must be organized and operated if it wants to be considered either charitable or not-for-profit for provincial purposes. For example, the Province of Saskatchewan has enacted the Non-Profit Corporations Act, 1995, and the Province of Ontario has similar legislation contained in the Corporations Act. Canada recently enacted the Canada Not-for-Profit Corporations Act.

While we cannot comment in detail on this legislation, we note that it appears that the criteria contained in the provincial "not-for-profit" legislation and in the federal Canada Not-for Profit Corporations Act are not the same as the criteria required to qualify for the tax exemption provided by paragraph 149(1)(l) of the Act. In particular, both the Saskatchewan and Ontario statutes only require that any profits or other accretions to the corporation be used in promoting the corporation's objects and activities. This suggests that organizations incorporated under these statutes can operate with a profit purpose, as long as that profit is used by the organization to support its objectives. Similarly, the Canada Not-for Profit Corporations Act provides that "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….except in furtherance of its activities…"

As discussed above, in our view, any profit purpose prevents an organization from being a 149(1)(l) entity. Consequently, it is possible for an organization to meet the requirements of federal or provincial "not-for-profit" incorporation legislation, but not qualify for the tax exemption provided under paragraph 149(1)(l) of the Act.

(iv) 149(1)(l) Entities-Registration

The CRA does not maintain a list of organizations that qualify for the exemption provided by paragraph 149(1)(l) of the Act. Unlike charities, these organizations are not required by the Act to register with the CRA.

(v) XXXXXXXXXX Procurement Contract

Whether an organization that has earned a profit qualifies for the tax exemption provided under paragraph 149(1)(l) of the Act is a question of fact. If the profit was incidental and unanticipated, the organization may still qualify as a 149(1)(l) entity. However, if the organization planned to earn a profit when it entered into the contract- for example, if the contract specifically contemplated a "mark-up"? the organization would not qualify for the tax exemption.

We trust that these comments will be of assistance.

Yours truly,

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Non-Profit Organizations and Aboriginal Issues
Financial Sector and Exempt Entities Division
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ENDNOTES

1 See also Canadian Bar Insurance Association v. Her Majesty the Queen, 99 DTC 653 (TCC).

2 See also the comments of Bowman J. from L.I.U.N.A. Local 527 Members' Training Trust Fund v. HMQ, 92 DTC 2365 at page 2380, where he refers to the taxpayer having neither a primary nor secondary profit purpose.