MaRS White Paper Series

Social Entrepreneurship Series

Legislative Innovations

Enabling Solutions to Complex Social Problems

Social entrepreneurs recognize social problems and use creative approaches to design, establish and manage ventures to make social change and achieve a positive economic return. This series of white papers explores issues of importance to the emergence of a strong social venture marketplace in Ontario.

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OGILVY RENAULT

Ontario

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Introduction

The MaRS social innovation team (SiG@MaRS) is actively developing programs to support the launch and growth of social ventures, enhance the skills and networks of social entrepreneurs, explore new instruments of social finance, foster opportunities for technology platforms to help scale social ventures and build the social enterprise community.

This white paper is part of a series that explores the opportunities and challenges supporting the growth of social ventures in Ontario. One identified challenge is the lack of a hybrid legal structure for social ventures in Ontario similar to structures introduced in the U.K. and the U.S. to promote the growth of social ventures in those market places.

Ogilvy Renault LLP was engaged by MaRS Discovery District, with generous support from the Government of Ontario, to complete a comparison of existing legal organizational structures in Ontario that may be used by social ventures with new U.S. and U.K. based structures that have been implemented, assessing the viability of implementing a new structure for Ontario. The working group from Ogilvy Renault LLP and MaRS has developed a recommendation for legislative changes to create a new legal structure, which could be implemented for the benefit of Ontario's social entrepreneurs.

In developing this white paper and a recommended new legal structure for Ontario's consideration, the authors focused on the achievement of three objectives. The primary objective is to increase capital directed at the community for delivering social and/or environmental benefits. The two secondary objectives were, firstly, to simplify and clarify the legal structures and permitted activities by creating a new form of organizational vehicle, and secondly, to provide a brand for social enterprise, social finance and community benefit, thus providing legitimacy and enhanced profile for such activities. Each of these secondary objectives will facilitate the raising of capital, which can be applied for the benefit of the community.

What is a social venture, social enterprise or community enterprise?

MaRS defines social ventures to include for-profit social purpose businesses and not-for-profit social enterprises. The "for-profit" and "not-for-profit" labels exist mainly to reflect the current legislative framework that Ontario's social entrepreneurs must creatively work within to operate their emerging businesses.

Richard Bridge and Stacey Corriveau, in their paper titled Legislative Innovations and Social Enterprise: Structural Lessons for Canada, define a "Social Enterprise or Community Enterprise" as a name for "organizations or ventures that achieve their primary social or environmental missions using business methods by applying market-based strategies to today's social problems. The name Community Enterprise may better capture the essence of this type of venture as part of the middle ground between the state and the market."[1]

Federally and in Ontario, there is currently no legal definition of a Social Venture, Social Enterprise or Community Enterprise and those social entrepreneurs operating these organizations have set up under a variety of different legal forms to accomplish their missions. For purposes of this paper, we will use the term Community Enterprise to describe the new hybrid organization and legal structure that may be appropriate for the growth of this sector in Canada.

Ontario's current legal structures

The most common forms of legal structure in Ontario for Community Enterprises include the following:

For-Profit Corporations

- Incorporated under the *Business Corporations Act* (Ontario) (the "OBCA") or the *Canada Business Corporations Act* (federal) (the "CBCA"), with share capital

1 BC Centre for Social Enterprise: Legislative Innovations and Social Enterprise: Structural Lessons for Canada, by Richard Bridge and Stacey Corriveau, Feb 2009 – www.centreforsocialenterprise.com/f/Legislative_Innovations_and_Social_Enterprise_Structural_Lessons_for_Canada_Feb_2009.pdf

Not-For-Profit Corporations

- Incorporated via Letters Patent under the *Corporations Act* (Ontario) or *Canada Corporations Act* (federal)[2], generally without share capital

Co-operative Corporations

- Incorporated under the *Co-operative Corporations Act* (Ontario) or *Canada Cooperatives Act* (federal), either with or without share capital

- Each of these forms of legal structure could be the vehicle for an application to, among others, the Canada Revenue Agency ("CRA") to become recognized as a **Registered Charity** or to be considered a non-profit organization under the *Income Tax Act* (Canada). The CRA will scrutinize the Articles of Incorporation (or other constating documents) and the operation of the entity to ensure compliance with applicable tax requirements.[3,4] In our research, the authors noted that most community-oriented organizations used a structure without share capital.

Of 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 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.[5]

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.[6]

Considerations for set-up of a community enterprise

If a planned business activity will generate a blend of social and/or environmental benefits and revenues for an organization, then one should consider launching a Community Enterprise. Under current legislation in Ontario, there is no concept or legal structure that combines the benefits of both the for-profit and not-for-profit worlds. The organizers must carefully consider the current legal environment and existing legal structures and requirements associated with for-profit, not-for-profit, registered charities and co-operative corporations, before setting up an organization in Canada. The organizers will need to hire qualified legal counsel to assist with the process and should choose a firm that is knowledgeable and experienced with the broad range of structures that may need to be considered for use by a prospective Community Enterprise.

The organization should ask this key question:

What is the underlying nature and intent of profit-making activities of the operation and what will the profits be used for?

1. If there is an expectation that there will be a broad range of profit-making activities to generate levels of profit that are similar to or slightly less than (due to the social or environmental benefits) traditional non-community enterprises, then the organizers will likely choose a for-profit organization structure from the current legal options; this structure could be referred to as a social-purpose business.

   Pros: This structure will provide the most flexibility in terms of the business activities that can be undertaken. It will enable the business to attract traditional

2 New legislation entitled the *Canada Not-for-profit Corporations Act* will replace Parts II and III of *Canada Corporations Act*. Once proclaimed into force (which date is yet uncertain), all new not-for-profit corporations at the federal level will be established under the *Canada Not-for-profit Corporations Act*, and all existing federal non-share capital corporations that are subject to Part II of the *Canada Corporations Act* must apply for continuance under this new statute. Please see "Pending updates to Ontario/Canadian legislation" section of this whitepaper.

3 CRA, Bulletin IT-496R Non-Profit Organizations – www.cra-arc.gc.ca/E/pub/tp/it496r/it496r-e.pdf and see CRA, Bulletin RC 4108 Registered Charities and the Income Tax Act – www.cra-arc.gc.ca/E/pub/tg/rc4108/rc4108-02e.pdf .

4 The authors note that while in theory a corporation incorporated under a business law statute could apply to register as a charity or be considered a non-profit organization for income tax purposes, in practice it may be onerous to demonstrate to the CRA that the relevant entity structure, governance and operational requirements have been satisfied.

5 BC Centre for Social Enterprise: Legislative Innovations and Social Enterprise: Structural Lessons for Canada, by Richard Bridge and Stacey Corriveau, Feb 2009 – www.centreforsocialenterprise.com/f/Legislative_Innovations_and_Social_Enterprise_Structural_Lessons_for_Canada_Feb_2009.pdf

6 Canadian Registered Charities: Business Activities and Social Enterprise – Thinking Outside the Box – Terrance S. Carter and Theresa L.M. Man, Carters Professional Corporation, October 24, 2008 (as presented at National Centre on Philanthropy and the Law Annual Conference: Structures at the Seam: The Architecture of Charities' Commercial Activities) - www.charitylaw.ca/seminars.html.

investment and debt to scale business activities and will make it possible to distribute any profits to investors and lenders in exchange for the risk they are taking.

Cons: The organization will not be able to rely on tax-deductible donations as a source of funding and may be restricted from receiving some forms of government funding. The organizers and board of directors may also have concerns about how to protect the social mission in a legal structure that is flexible and can be changed by current or future shareholders (note however that there is an emerging solution for this issue in Ontario, described below in the B Corporation section).

2. If, in the course of achieving a social mission, an entity generates profits through profit-making activities which meet the definition of a "related business" (as determined by the CRA), organizers will likely choose to become a social enterprise in a registered charity legal structure. "Related businesses" are defined as activities related to or ancillary to the charitable objects but can also be unrelated activities, as long as substantially all (more than 90%) of the persons employed in the profitable activity are volunteers and not remunerated. For example, a storefront operated by a charity and staffed by its volunteers, selling donated goods may be considered a related business.

   Pros: This structure is most commonly understood by individuals working in the social sector in Canada and is designed to ensure that all assets of the organization are protected and used for achievement of the social mission. As a registered charity, the organization can issue tax receipts for donations, is generally eligible for government grants, and does not pay income tax on its earnings.

   Cons: There are significant limitations on the business activities that can be undertaken and who may be employed for those activities (mainly limited to volunteers). As a result, these social enterprises generally do not scale to their full potential. Contributing to the smaller scale are several factors: limited access to investment capital as profits cannot be distributed to members or shareholders; aversion to borrowing since charity boards have a special fiduciary duty of care to protect charitable property and are, therefore, more risk averse than their for-profit counterparts; and the inability of charities to accumulate excess profits for future use by virtue of a disbursement quota, which requires a charity to spend 80% of the value of receipted donations of the previous year on charitable purposes.

3. If the organization is an innovative social enterprise that wants to achieve scale, the organizers will likely rule out a registered charity structure and consider the not-for-profit organizational structure ("NFP"). NFPs can engage in profit-making activities provided that the activities are compatible with the not-for-profit objects of the organization and the profits are used exclusively for promoting its stated goals. Possible indicators that an NFP may be operating an impermissible profit-making business include the following: (i) operation in a normal commercial manner; (ii) goods and services are not restricted to members and their guests; (iii) operation on a profit basis rather than a cost-recovery basis; and (iv) business is operated in competition with taxable entities carrying on the same business.[7]

   Pros: This structure is commonly used in the social sector and so long as the main purpose of the entity is not-for-profit, an accumulation of excess profits may be permitted from year to year. NFPs are generally tax-exempt, so long as they are organized and operated exclusively for social welfare; civic improvements; pleasure or recreation; or any other purpose except profit. NFPs will lose their tax-exempt status if income is payable to, or available for, the benefit of members or shareholders or if the entity has power at any time to declare and pay dividends. NFPs are not generally restricted from borrowing money and repaying principal and interest to lenders.

   Cons: The organization will not be able to issue tax receipts for donations, which may impact funding. NFPs can, however, still accept donations and some groups receive a significant number of donations from supporters who believe in the particular cause and are willing to forego the tax receipt. At the same time, the organization will not be able to attract investment from traditional investors since distributing earnings would result in loss of tax-exempt status. In addition, if the organization is financially successful, it may also lose its tax-exempt status if the accumulated profits are beyond what the CRA believes is required to operate the NFP

7 CRA, Bulletin IT-496R Non-Profit Organizations – www.cra-arc.gc.ca/E/pub/tp/it496r/it496r-e.pdf.

or if such accumulated profits are for the purpose of funding future capital projects.[8]

4. If the organization is one that will provide a centralized set of services to a group of members who will have an equal vote on how the organization will be operated, and the business activities of the organization will be operated as nearly as possible on a cost recovery basis, the organizers will likely choose a Co-operative Corporation structure.

   Pros: This structure is well-established (both in Ontario and federally) and already reflects the concept of benefits for the community.

   Cons: This organization is only suited to a member-run initiative and the organization may lose its co-operative status if its affairs are not conducted on a co-operative basis or if, for a period of three years or longer, it has conducted 50% or more of its business with non-members.[9] A co-operative is not exempt from paying tax unless it specifically files its set-up documents on that basis and complies with general not-for-profit conditions and regulations described above.

   Today, there is no right or wrong answer to whether one should establish a Community Enterprise as a not-for-profit social enterprise (stand-alone or operating as part of a registered charity), a for-profit social-purpose business or a co-operative. In today's legal environment, social entrepreneurs need to work with legal counsel and their boards and advisors to determine which of the existing legal structure alternatives works best for their situation and then, where possible, add ancillary agreements and process to make the structure work for the organization and its stakeholders.

   For registered charities, Canadian lawyers Terrance Carter and Theresa Man explored the use of intermediary entities, such as for-profit companies, not-for-profit companies, a business trust or a combination of these entities to be operated on a parallel basis with a registered charity, operating the charitable programs through the registered charity, while compartmentalizing the operations of the business activity in an intermediary entity. They note that each option has pros and cons and its own limitations; in their paper Canadian Registered Charities: Business Activities and Social Enterprise – Thinking Outside the Box. Carter and Man advise that "care must be taken in structuring and implementing these arrangements in order to ensure that the objectives of the organization are achieved".[10]

Pending updates to Ontario/ Canadian legislation

The *Canada Corporations Act*, which governs federally incorporated NFPs and charities, was enacted in the early 1900s and there has been little change since that date until recently. Bill C-4, the *Canada Not-for-profit Corporations Act*, is the latest of several legislative attempts to modernize the *Canada Corporations Act,* and is designed to improve governance, accountability, and administration of existing and future NFPs and charities that incorporate federally; however there is nothing in the new legislation regarding Community Enterprises. Bill C-4 received Royal Assent on June 23, 2009, but has not yet been proclaimed into force.

In Ontario, the *Corporations Act* (Ontario) is also out-of-date and is in need of revision. The Ontario government has consulted with stakeholders as part of its review of the *Corporations Act* (Ontario) and has progressed in updating other legislation relevant to charitable entities with the passing of Bill 212 (the *Good Government Act,* 2009), which received Royal Assent in the Ontario Legislature on December 15, 2009.[11] This new legislation has brought much needed change to how charitable entities in Ontario are regulated and brings Ontario more in line with the rest of Canada. Of particular note, the *Charitable Gifts Act*, which restricted charitable entities from owning more than a 10% interest in a for-profit business, is now repealed and the *Charities Accounting Act* has been amended to permit charitable entities to hold real or personal property for as long as such property is being used for its charitable purposes. Other amendments provide the Public Guardian and Trustee with expanded powers to request business records and other financial information relating to any business in which a charitable entity has a substantial interest.

8 CRA, Technical Interpretation 2009-0337311E5

9 *Co-operative Corporations Act* (R.S.O. 1990, c. C.35), ss. 143, 144.

10 Canadian Registered Charities: Business Activities and Social Enterprise – Thinking Outside the Box – Terrance S. Carter and Theresa L.M. Man, Carters Professional Corporation, October 24, 2008 (as presented at National Centre on Philanthropy and the Law Annual Conference: Structures at the Seam: The Architecture of Charities' Commercial Activities) - www.charitylaw.ca/seminars.html.

11 http://www.ontla.on.ca/web/bills/bills_detail.do?locale=en&Intranet=&BillID=2235.

Hybrid organizational structures – U.K. and U.S. examples

In the U.K. and U.S., the emergence of a larger number of social ventures achieving reasonable scale has been aided by the creation of hybrid corporate legal structures, such as the "B Corporation" in the U.S., which has expanded to Canada; the "Community Interest Company" in the U.K. and; the low profit, limited liability corporation in the U.S. Experts believe that these legal structures provide better opportunity for social ventures to attract investment and scale their operations. The authors have completed a review of these structures implemented in other jurisdictions and have summarized their findings below.

Overview: B Corporations

B "Beneficial" Corporations are not themselves a new legal form of business enterprise, but rather a certification for which any business entity may apply. The certification was created by a U.S. not-for-profit organization, B Lab, as a means to allow corporations to define themselves to consumers and investors as socially and environmentally responsible business entities. Canadian corporations may also apply for certification.

As envisioned by B Lab, B Corporations seek to :[12]

1. Meet transparent and comprehensive standards of social and environmental performance;
2. Legally expand their corporate responsibilities to include consideration of stakeholder interests; and
3. Amplify the voice of sustainable business and for-profit social enterprise through the power of the unifying B Corporation brand.

In March 2009, MaRS client Better the World Inc. (www.BetterTheWorld.com), a for-profit online company that raises funds for charity partners by delivering cause marketing campaigns to targeted consumers, was named Canada's first B Corporation. It joins more than 190 corporations in the U.S., representing over 31 industries and a $1 billion marketplace, which use their businesses as drivers to help resolve global social and environmental issues.

The group is diverse and includes established entity King Arthur Flour (www.kingarthurflour.com), one of America's oldest flour companies and leading New England brands, as well as several start-ups seeking to deliver social impact and environmental benefits. Three B Corporations were recently named to Business Week magazine's list of top five social entrepreneurs:

- Better World Books (www.betterworldbooks.com) – a vendor of used/new books that uses profits to support literacy initiatives
- Impact Makers (www.impactmakers.org) – a professional IT and management consulting firm, whose profits are used to support charitable community partners
- Clean Fish (www.cleanfish.com) - a provider of sustainable and safe seafood.[12]

12 B Corporation website - www.bcorporation.net.

Certification

To become a B Corporation, a business entity must achieve a threshold score (80 out of 200) on the B Ratings System (the "Survey"), which assesses a company's social and environmental performance. The Survey was created by B Lab and requests disclosure from the business entity of a number of its practices, including democratic decision making, employee benefits, philanthropy, environmental policies, political activity, diversity and sourcing.[13] Every year, 10% of B Corporations are audited by B Lab. In an audit, B Corporations are asked to validate and prove each of their answers in the Survey. If the score falls below the passing grade, the B Corporation has 90 days to make improvements.

Corporate statutes — recognition of stakeholders

A B Corporation must amend its articles of incorporation (or other set-up documents) to expressly consider the interests of other stakeholders in addition to shareholders, including employees, the community and the environment. In addition to filing such amendments with the applicable regulator in accordance with the laws governing the B Corporation's underlying business form, copies of such amended documents must also be submitted to B Lab.

In the U.S., the corporate statutes of certain states do not expressly permit corporate directors to consider other stakeholder interests, instead imposing requirements to maximize shareholder value. For corporations incorporated in such states, B Lab recommends either re-incorporating in a state with more permissive constituency laws, or to incorporate as a Limited Liability Corporation ("LLC"), whose members can customize management priorities through the LLC's operating agreement.

In Canada, corporate directors under both the CBCA and the OBCA must act honestly and in good faith with a view to the best interests of the "corporation". 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.[14] However, the extent to which directors are permitted to consider the interests of outside stakeholders is not entirely settled.

Given that the Canadian and Ontario statutory framework has been interpreted to permit directors to consider other stakeholder interests, it should therefore be likely that amendments to a corporation's articles to expressly include consideration of other stakeholders (in addition to shareholders) may be permissible without contravening directors' duties under the CBCA and OBCA.

However, a corollary issue could arise as a result of such express consideration of additional stakeholders: this may increase the possibility of certain stakeholders being able to bring successful oppression remedy actions against the corporation, as the amendments to the corporation's articles of incorporation may legitimize and elevate such stakeholders' expectations to have their interests taken into consideration in the directors' decision-making process. In corporate law, an oppression remedy is a statutory right available to shareholders and others to bring an action against a corporation when the conduct of the company has an effect that is oppressive, unfairly prejudicial to or unfairly disregards the interests of a security holder, creditor, director or officer of the corporation. [15] The oppression remedy has generally been used in Canadian law to rectify situations associated with minority shareholders, but the range of possible complainants is broader than shareholders.

Tax Matters

Currently, B Corporations do not have any preferential tax treatment. B Lab indicates that it is working toward eventual recognition of B Corporations as a distinct legal entity at both U.S. State and Federal levels in order to qualify B Corporations for tax incentives to reduce B Corporation corporate taxes and capital gains taxes for investors.

Overview: Community Interest Company

A community interest company ("CIC") is a new type of limited liability company created in the United Kingdom in 2005 under the *Companies (Audit, Investigations and Community Enterprise) Act 2004*. The intent was to create a legal form whose primary objective was to use its assets and profits for the benefit of the community, and create a recognizable "brand" for social enterprises that wanted to adopt a familiar limited company form.

13 The B Ratings System is in the process of revision, which is expected to be completed in early 2010.

14 See *BCE Inc. v. 1976 Debentureholders*, 2008 SCC 69; see also *Peoples Department Stores Inc. (Trustee of) v. Wise*, 2004 SCC 68.

15 *Business Corporations Act* (R.S.O. 1990, Chapter B.16), s. 248.

Generally, under U.K. law, a limited liability company can be limited by shares (like a corporation with a share structure, with shareholders' liability limited to any amount owing to the company in respect to their shares) or limited by guarantee (members agree to be liable to contribute a specified amount in the event of the company being wound up, usually a nominal amount). Similarly, CICs may be either limited by shares or limited by guarantee.

CICs are formed under the *Companies Act 1985* and are subject to general company law like other companies registered under the *Companies Act 1985*. The detailed rules under which CICs operate are contained in the *Community Interest Company Regulations 2005* (the "Regulations").

CICs are free to operate more "commercially" than charities, but CICs must: (i) pass a "community interest test"; (ii) adhere to certain "asset lock" restrictions, and (iii) disclose their activities annually through an annual community interest report placed on the public record.

Formation: Community Interest Test

The formation and registration of a new CIC is similar to that of any limited company in the U.K. New organizations can register by paying the applicable fees and filing the appropriate forms and memorandum and articles of association, however a "community interest statement" must also be submitted to the Registrar of Companies for England and Wales. The community interest statement must contain a declaration that activities will be carried on for the benefit of the community and a description of how such goals are to be achieved. All documentation is then forwarded to the Regulator of Community Interest Companies (the "Regulator"), who ultimately determines whether the company satisfies the necessary preconditions to become a CIC. Existing companies and charities may also convert to a CIC (although charities will lose their charitable status).

A necessary precondition to forming a CIC is that it must satisfy a "community interest test". This 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 group of individuals may constitute a community if they share a readily identifiable characteristic that is not shared by other members of the larger community.

A CIC will not satisfy the community interest test if it carries on certain political activities, or if a reasonable person might consider that its activities are carried on only for the benefit of the members of a particular body or the employees of a particular employer.

At time of writing this paper, there are almost 3,400 registered CICs operating in the U.K.[16] across many sectors. Here are a few examples:

- Education Solutions Direct CIC (www.edsols.org), a specialist education and training consultancy serving disadvantaged community members
- Healthy Planet Community CIC (www.healthyplanet.org), a trading company with similar goals to Healthy Planet Foundation (charity) addressing environmental and health issues and related education
- Gateway Family Services CIC (www.gatewayfs.org), which aims to reduce inequalities in learning, employment and health, through supported training and employment opportunities in community health service delivery

Other examples are child-care companies, community fitness ventures, music tuition initiatives, arts projects, employment initiatives, martial arts groups, anti-smoking projects, fashion and design development programs, ethnicity projects, volunteer worker support groups, training programs for unemployed, catering industry training initiatives, recycling promotion, community waste management, learning difficulty or other disability support networks, and social or sports clubs.

16 Community Interest Company Regulator website - http://www.cicregulator.gov.uk/.

Asset Lock

The asset lock provisions prescribed in the Regulations are intended to ensure that the assets of the CIC are either retained within the CIC or used for community purposes. This asset lock is touted as a feature that gives confidence to those funding CICs that the assets will be used for the benefit of the community. The main elements of the asset lock are as follows:

1. CICs may not transfer assets at less than full market value, unless they are transferred to another asset locked body (such as to another CIC or a charity);
2. Payment of dividends (other than to another asset locked body) are subject to a cap of 5% above the Bank of England base lending rate, and a maximum aggregate cap of 35% of the distributable profits; however unused dividend capacity from year to year may be carried forward for five years;
3. Dividends may only be declared by ordinary or special resolution of the members, i.e. directors cannot declare a dividend without support of the members;
4. If a rate of interest is linked to the performance of the CIC, such interest rate is capped at 4% above the Bank of England base lending rate; and
5. On dissolution, any surplus assets must be transferred to another asset locked body.

The Regulator is responsible for ensuring that the asset lock is maintained.

Company governance

As with any private company, CICs are controlled by those appointed to its board of directors and by those who become shareholders/members. The precise structure is a matter for each CIC to determine.

Tax matters

CICs do not receive any tax advantages by virtue of their legal status, and the business pays the usual corporate taxes. If a CIC donates to a charity, it will be able to deduct the amount of any such donations as a "charge" in calculating its profits for corporate tax purposes under U.K. tax laws, provided that the donation is a payment of money that is not a distribution of profit such as a dividend. Charitable donations cannot be used to create or increase trading losses, and cannot be carried over from year to year. It appears that such donations can be used to offset 100% of a company's profits.

Review of CIC regulations

The Regulator is currently considering modification to the initial Regulations implemented for CICs in the U.K. during 2005. The two main areas of discussion between the Regulator, CICs and their investors are caps on dividends/interest rates and the lack of tax benefits for CICs and their investors.

Overview: Low Profit Limited Liability Company

The low-profit limited liability company ("L3C") is a legal company structure based on the existing limited liability company structure ("LLC") under U.S. law. In May 2008, Vermont was the first U.S. State to adopt L3Cs into their LLC laws, and the structure has since been signed into law in a handful of other U.S. States, with pending legislation in various other states.

The primary purpose of the L3C is to further the accomplishment of one or more charitable or educational purposes, with profit as a secondary goal. The L3C form 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 U.S. 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.

The traditional LLC provides a flexible ownership structure whereby different owners of a single company can receive different economic benefits. This enables different classes of investors (individuals, government agencies, non-profits, foundations and for-profit businesses) to invest with varying degrees of risk and return. It is intended that foundations

provide the initial high-risk investment to provide the financial backbone of the L3C while various other tranches of investors invest at lower levels of risk.[17, 18]

LLC form and governance

As a type of LLC, the L3C is subject to the same laws to which other LLCs are subject. Organizing the L3C is the same as for other LLCs except that the articles of organization must include specific statements regarding its objectives and limitations (see "Program-Related Investments" below), and the L3C designation must be indicated. Filing of the articles of organization is with a State's LLC filing office (usually part of the Secretary of State's office).

LLCs are a hybrid legal structure combining the limited liability characteristic of a share capital corporation with the availability of pass-through income taxation of a partnership or sole proprietorship. LLC members are the owners of the LLC. Much like a partnership agreement, the LLC's "operating agreement" may address management matters, and may dictate a member's right to receive distributions or other rights over the LLC in proportions other than their membership interests.

LLCs may be member-managed or manager-managed, as specified in its operating agreement. If member-managed, the LLC may be governed by a single class of members (approximating a partnership) or multiple classes of members (approximating a limited partnership). If structured with manager management, the governance approximates a two-tiered structure akin to the corporate model, with managers typically holding powers similar to corporate officers and directors.

Program-related investments

Program-related investments (PRIs) are a type of investment made by private foundations, which are governed by U.S. Federal tax laws. Such investments (usually in the form of loans, equity investments or guarantees) are often made by private foundations in for-profit business ventures involving high risk and/or low return to support a charitable project or activity. PRIs are not grants, therefore such funds invested are expected to return to the foundation (through loan repayment or sale of its equity investment), and are to be re-invested into another PRI or disbursed as a grant within one year of return of capital. In this way, PRIs live on through their potential to be returned and re-invested.

Under U.S. Federal tax laws, private foundations are required to distribute 5% of their capital each year for charitable purposes, and foundations investing in qualified PRIs may count such invested funds toward the 5% distribution requirement.

According to Foundation Centre[19], in July 2009, there were 53 L3Cs operating in Vermont and other states. Some examples of L3C entities include:

- Monkton Community Coffeehouse (www.monktonvt.com), a multi-use community gathering place in an historical building
- Cool Pass (www.carbonpass.com), a carbon off-setter program that assists low-income home owners with obtaining EnergyStar efficient furnaces, hot water heaters, insulation and other home upgrades
- Faithful Travelers (www.faithfultravelers.com), a travel service that matches faith-based customers with service-based excursions
- Other examples are in carbon trading, alternative energy, food bank processing, social services, social benefit consulting and media, arts financing, job creation programs, economic development, housing for low income and aging populations, medical facilities, environmental remediation, and medical research.

17 The L3C, the For Profit with the Nonprofit Soul http://www.americansforcommunitydevelopment.org/supportingdownloads/Introducing_the_L3C.ppt#1.

18 Americans for Community Development – Overview. By Robert M. Lang Jr. http://www.americansforcommunitydevelopment.org/supportingdownloads/ACDOverview.pdf.

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Currently, it is reported that few foundations in the U.S. choose to make significant PRIs because of the perceived difficulty and expense of ensuring that a proposed investment will qualify as a PRI. The L3C structure is intended to mitigate such concerns because the L3C must be organized and operated to satisfy the U.S. Federal tax rules for qualifying as a PRI. This should enable a foundation's proposed investment to qualify as a PRI and streamline the approval process. As such, the L3C's organizing documents must contain the following requirements, which mirror the requirements in the U.S. Internal Revenue Code governing PRIs:

1. The company must significantly further the accomplishment of one or more charitable or educational purposes, and would not have been formed but for its relationship to the accomplishment of such purposes;

2. No significant purpose of the company is the production of income or the appreciation of property (though the company is permitted to earn profit); and

3. The company must not be organized to accomplish any political or legislative purpose.

Financing structure

L3Cs are intended to have at least two tranches of capital which will possess differing allocations of risk and reward. A high-risk junior tranche is intended to be provided by foundations in the form of PRIs, from which foundations are willing to accept below-market rates of return. By allowing foundations to absorb excess risk and receive below-market returns, the junior tranche provides the backbone of the L3C and positions the L3C to attract additional capital from other investors seeking market or near-market returns.

Senior tranches of capital are intended to be provided by investors who may have the desire to invest in projects that provide tangible social benefits. With the junior tranche in place, the L3C can offer market rates of return at acceptable levels of risk to institutional and other traditional investors. Mezzanine tranches may also be created for other socially conscious investors who may be willing to forego market-rate returns in favour of accepting part of the return in the form of enhanced social benefit.

Tax matters

For U.S. income tax purposes, LLCs are taxed as flow-through entities like partnerships or sole proprietorships. This means that the LLC does not pay taxes on its income, but instead, its members will pay tax on their distributive share of LLC income, even if no funds are distributed by the LLC to the members. It is possible that the allocation of income (or loss) may be altered by the members in the LLC's operating agreement, subject to applicable U.S. tax laws.

LLC members may elect for the LLC to be taxed like a corporation such that there is taxation of the LLC's income prior to any dividends or distributions to the members, with dividends or distributions being taxed in the hands of the members at their respective tax rates.

Pros and cons of U.K. and U.S. hybrid structures

All three hybrid structures have the benefit of legitimizing Community Enterprises and raising their profile in the investment and/or general community. They also permit a community purpose to be defined that is much broader than the current charitable purpose definition and permit directors to be paid and have the same rights and duties as other corporate directors. On the con side, the hybrid structures all have limited tax benefits for both the Community Enterprises, who do not benefit from special tax rates, and their investors, who do not receive any special incentives for investing in this type of hybrid organization. However, the L3C does have the added benefit of a flow-through taxation model and it appears that CICs are permitted to use charitable donations to offset 100% of their taxable profits. Other pros and cons of the hybrid structures are described on the following page.

Pros	Attracts Investment	Governance / Oversight	Implementation in Ontario
B Corp	• No cap on investor returns • Companies may accommodate both traditional and social investors	• No additional government regulatory oversight	• No additional government regulatory oversight
CIC	• Relatively flexible capital structure • Facilitates capital raising by permitting dividends on shares issued to investors	• Light touch regulator, providing legitimacy but less onerous than charities regulator	• Existing Ontario/Canada legal structures are similar to U.K. legal structures
L3C	• No cap on investment returns and facilitates capital raising by enabling varying returns including market rate returns for investors • Streamlines PRI process for private foundations, enabling funds to be recycled (versus one-time grants) • Flow through taxation	• Regulation through standard State process for corporations	

Cons	Attracts Investment	Governance / Oversight	Implementation in Ontario
B Corp	• Investors seeking social or environmental returns may question legitimacy since there is no government regulation	• Not sanctioned by any government body, oversight provided by non-profit corporation, B Lab	• May increase class of likely complainants under oppression remedy beyond corporate shareholders • Performance criteria may need amending for Canadian context
CIC	• Dividends to investors are capped • Payment of interest related to performance of CIC is capped	• New regulatory organization required	• New category of corporation must be created
L3C	• There may be a public perception issue with using charitable funds to backstop market or near-market rate returns for investors	• On a practical level, oversight is only provided by shareholders	• LLC business form does not exist in Canada • PRI concept does not exist in Canada. An L3C would need to be considered a "qualified donee" under tax law, which is currently limited to those permitted to issue tax receipts

A recommendation for Ontario

The working group considered both the L3C and CIC legislation as possible base inputs to a recommendation for Ontario. Since Ontario does not have existing legislation permitting limited liability companies (LLCs), the group concluded that it was not practical to recommend creating an LLC vehicle simply for the purpose of creating L3Cs despite the fact that the L3C form of vehicle would be most compelling due to its flexibility and the ability to eliminate a level of taxation which would make it attractive to non-taxable investors.

Thus, the group focused on creating a new form of vehicle, similar to a CIC, as simply as possible by recommending the following:

1. Ontario could pass a new statute that would be more likely to assist in creating brand awareness, profile and legitimacy for a new community benefit vehicle. The legislation would provide for the establishment of Community Enterprise Corporations ("CECs"), a working name for the purposes of this white paper, but other names that could be considered include Social Enterprise Corporation, Low-Profit Corporation, or Blended-Value Corporation. The authors' views is that the statute would borrow heavily from provisions of the new *Canada Not-for-profit Corporations Act* and to a certain extent, the *Companies (Audit, Investigations and Community Enterprise) Act 2004* (England and Wales) and the associated *Community Interest Company Regulations 2005* (UK), with respect to such matters as corporate structure, governance, financial accountability, etc. Pursuant to the statute, a new form of low-profit corporation with corporate objects that would include promoting community interests and making a profit would be created. Some highlights would include:

    - The objects of the corporation must be for community benefit, but would not preclude profit as an object.
    - A CEC would have the ability to issue shares in classes or series and the ability to borrow money and pledge its assets and give security therefore.
    - CECs would adopt the unique "asset lock" feature of the CICs whereby capital and assets devoted to community benefit are required to continue to be devoted to such objects, except to the extent distributed to shareholders or debt holders. The group believes that this is an important distinguishing feature, which ensures that the community benefit is ultimately served.
    - To distinguish CECs from other vehicles, it is necessary that a CEC be allowed to make a profit and return it to its security holders; however, given the community benefit nature of their organization, it should be a low profit return. For this reason the authors felt that a capped return mechanism for shareholders and debt holders, similar to that used by CICs would be appropriate. There is some current debate in the U.K. on the level of the capped return and the authors are certainly open to discussion with Ontario and other CEC stakeholders. Suggestions include a combination of either: (i) the return on a loan or dividends being capped at a benchmark rate, such as long-term Government of Canada bond rates, bank prime rates or Bank of Canada overnight rate, plus a modest amount; or (ii) a cap on distribution of profits at a certain percentage in any one year. As noted above, the current cap for CIC organizations in the U.K. is 35% of distributable profits, but is currently under review by the CIC's regulator, which has heard compelling arguments from investors about adequate compensation levels for being early investors in the emerging sector of social venture finance. This issue will need careful consideration to strike the right balance to facilitate capital-raising for the CECs but also to ensure that these vehicles do not attract capital better suited to supporting full-profit ventures, which in an indirect way through creation of jobs and wealth, also provide substantial benefits for the Ontario community.
    - Like normal business corporations, the CECs would be run by a board of directors, who could be compensated and would have the power to make decisions on all matters, except for fundamental ones, in a fashion similar to that of a business corporation. The holding of annual meetings of shareholders and other corporate governance practices and legal requirements would also apply to these vehicles to ensure that community benefits are being pursued. For example, the board of

directors or a committee, much like an audit committee, governance committee, or investment committee, would be responsible for ensuring that the projects, grants or other activities undertaken by the CEC are consistent with and fulfilling the objects of the CEC. Such committee could be required to report to shareholders on such review on an annual basis.

2. In order to make the new CEC vehicle effective, other legislative changes may be necessary, or a careful analysis would have to be made to ensure that such changes are not required. For example, it may not be appropriate for a CEC, which could decide to hold property for charitable purposes, to be subject to the full breadth of legislation to which the Public Guardian and Trustee has regulatory oversight.

3. Drawing on CIC experience, the establishment of a regulator with a "light touch" and a missionary zeal for the CECs would be most helpful in providing legitimacy and profile that will enhance the capital-raising activities of such vehicles. It is likely not appropriate, given the mandate of the Public Guardian and Trustee, that it be the CEC regulator.

4. As the CEC vehicle would be issuing securities, careful consideration of the application of the *Securities Act* (Ontario) would also have to be considered. It is likely that existing exemptions from the prospectus requirements would apply, as a CEC would likely be considered to be a "private issuer" or it could rely on the accredited investors or $150,000 exemptions in most cases. However, analysis of the likely and desired investors in a CEC would have to be undertaken to ensure that such exemptions may be relied upon by such investors. The requirement for registration under the *Securities Act* (Ontario) of anyone involved in the business or trading or distributing CEC securities would also have to be considered.

5. A tax incentive for CEC organizations would be very attractive for investors and likely help make CECs more successful. We would suggest Ontario consider a modest change to the Ontario corporate tax rate so as to provide some incentive for capital to flow to these new hybrid corporate vehicles.

How federal changes could improve the CEC implementation

1. In addition to the proposed modest Ontario tax rate change, the Federal Government could also be approached with a similar request to further improve the attractiveness of CECs to potential investors.

2. One change in federal legislation that would be very helpful is an amendment to the definition of "qualified donee" in the *Income Tax Act* (Canada) to include CECs. A very attractive feature of the L3Cs in the U.S. is that they qualify for PRIs (program-related investments), which enables them to obtain capital from private foundations as seed money or base capital to fund their operations and get an enterprise launched. The *Income Tax Act* amendment would provide the same benefit for a Canadian CEC. The authors did not, in the scope of this project, analyze the tax policy implications of such an amendment.

Conclusion

An opportunity exists to capitalize on regulatory changes that have taken place in the U.K. and U.S. and the experience they have gained implementing those changes. Their knowledge can be used as a base to effect change in Ontario that will assist social entrepreneurs to raise the necessary capital to scale their business activities. Ogilvy Renault LLP and MaRS will present the recommendations in this white paper to the Ontario government and stimulate a dialogue between government leaders and policy makers, members of the social enterprise community in Ontario and those that have lead the way to hybrid corporate legal structures in the U.K. and the U.S.

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