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Ottawa, May 15, 2014

Mr. Paul Halucha
Director General
Marketplace Framework Policy Branch
Industry Canada
235 Queen Street, 10th Floor
Ottawa, ON K1A 0H5

Dear Mr. Halucha:

I am writing to you in response to the public consultation on the Canada Business Corporations Act. Specifically, we would like to take this opportunity to comment on the utility of socially responsible enterprises within the Canadian context.

Imagine Canada is the national umbrella organization for Canada's registered charities. There are approximately 85,000 registered charities in Canada, located in every community and ranging in size from small community-based organizations to large national and international organizations. Charities partner with communities, governments, and the private sector to help address many of the most intractable challenges society faces – be they economic, social, environmental, or health-related – and to provide educational, sporting, religious, and cultural opportunities that significantly enhance quality of life.

Charities have a vested interest in the creation of a distinct hybrid entity to the extent that the new entity both *complements* and *facilitates* the good work that charities do. Any discussion of a new hybrid structure must also involve discussions of the wider incorporation landscape as well as the corresponding legislation – beyond amendments to the Canada Business Corporation Act – that it will inevitably require. To that end, Imagine Canada makes the following recommendations, upon which I will expand.

1. **Prior to making a final decision on this issue, Industry Canada should ensure that the full range of public authorities and regulators with an interest in charities and socially responsible enterprises, together with the charitable sector, have jointly assessed the broader policy implications and identified potential unintended consequences resulting from the creation of a new hybrid structure at the federal level.**
2. **Should a decision be made to proceed with a hybrid structure, the federal government should reiterate its commitment to philanthropy by working to ensure that any investment incentives associated with a new hybrid structure do not negatively affect Canadian philanthropy.**
3. **Should the Canada Business Corporation Act be amended to facilitate the creation of hybrid organizations, the federal government should establish a regulator of hybrid organizations with both the capacity and the investigative and enforcement powers to ensure compliance.**

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Background and Context

Before expanding on our recommendations, allow me to provide some brief background and context so as to ensure that federal officials and charities have a common understanding of charities' current engagement in business-related activities that are relevant to this consultation.

Charities have long engaged in business.

Charities that engage in earned income activities meet the definition of 'socially responsible enterprises' provided by Industry Canada. Through earned income activities, that is to say, the sale of products, goods, and services, charities directly fulfill their charitable missions and diversify and sustain their revenues. In fact, the most recently available Statistics Canada data indicates that earned income was the sector's most significant source of revenue in 2008 (45 percent), eclipsing government funding (21 percent) and philanthropy (13 percent).[1] Some of the oldest and most well-known examples of socially responsible enterprises, such as exercise facilities run by YMCAs, thrift stores operated by Goodwill Industries, and gift shops operated by museums, have their roots within the charitable sector. The charitable sector has long used the commercial business model as a *tool* to achieve its social objectives.

Charities can already engage in business within the current legal and regulatory environment.

Charities can legally engage in earned income activity by either *operating* a related business or by *owning* an unrelated business. The choice will depend on the specific business activity and needs of the particular charity.

a) <u>Operation of related businesses</u>
Charities can engage in earned income activities that generate a profit directly through the *operation* of 'related businesses.' Regulatory guidance, provided by the Canada Revenue Agency, stipulates that related businesses must be run substantially by volunteers or be linked to and subordinate to the charitable objectives of the charity. These stipulations ensure that the resources of the charity are used only for the public benefit. When they are met, the related business can pursue profit, is exempt from paying taxes, and can use charitable funds in the operation of the related business.

b) <u>Ownership of unrelated businesses</u>
While the stipulations applying to related businesses safeguard the public interest, they can limit the ability of the charity to access the required financing to grow their related business. Furthermore, a charity is prohibited from engaging in 'unrelated businesses' altogether. Therefore, some charities prefer to engage in earned income activities indirectly through *ownership* of a separate entity, which houses the unrelated business. Profits can then flow back to the charity in the form of donations or dividends.

One of the entities commonly used to house charities' unrelated businesses is the private corporation. A private corporation is limited in neither the type of business activity in which it may engage nor in

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[1] The remaining revenue sources include membership fees (17 percent) and investment income (4 percent). These statistics exclude hospitals (including residential care facilities), universities, and colleges.

the type of financing it may accept. It can also distribute dividends to shareholders, which is a powerful incentive to attract investment and growth capital. Although private corporations must pay taxes on their income, they can donate up to 75 per cent of it to charity making their effective tax rate quite low.

Charities' could potentially make use of hybrid corporate structures.

Hybrid structures could be used to house charities' unrelated businesses. Hybrid structures are similar to regular corporations but are created with certain restrictions to ensure that resources will be used for the public benefit. Common restrictions of new hybrid structures include a 'community interest test' as a prerequisite for incorporation, which ensures that the organization is established for the benefit of the community; an asset lock, which ensures that the profits and assets of the organization are directed toward community interests; and dividend and interest caps, which limit the profits the hybrid organization can distribute to investors. Additionally, most legislation requires hybrid structures to report annually on the activities and spending of the organization including an explanation of how it has benefited society.

Given this context and charities' direct interest in the issue, Imagine Canada proposes a number of recommendations for your consideration.

Recommendations

1. *Prior to making a final decision on this issue, Industry Canada should ensure that the full range of public authorities and regulators with an interest in charities and socially responsible enterprises, together with the charitable sector, have jointly assessed the broader policy implications and identified potential unintended consequences resulting from the creation of a new hybrid structure at the federal level.*

This Industry Canada consultation deals specifically with the issue of a new hybrid structure as it relates to the Canada Business Corporation Act (or CBCA). However, such a structure may also require corresponding legislation beyond amendments to the CBCA. In addition, because the new hybrid structure will affect the charitable sector, attention must be paid to the regulatory regime governing charities. Public authorities and regulators with an interest in charities and socially responsible enterprises, such as the Department of Finance, Canada Revenue Agency, and Employment and Social Development Canada, together with the charitable sector, should be involved in joint consideration of a new federal hybrid structure to ensure consistency in federal policy. The federal government should also be cognizant of the provincial charity and business regulatory landscape to ensure that there is alignment across jurisdictions. Conflicting regulations or policy interpretations at any of these levels could create barriers affecting the ease with which charities make use of a new hybrid structure.

One example of what we mean by a broader policy implication for the federal government involves the business support programs established by a number of departments and agencies, including Industry Canada. As charities look to adopt the hybrid model, they will require access to strategic business advice and legal counsel. The eligibility requirements of federal business development programs, many of which remain primarily targeted to for-profit corporations, should be further expanded to include charities, nonprofits, and hybrid organizations. In addition, federal departments responsible for these

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business development programs will need to be ready to meet and respond to the increased demand presented by charities', nonprofits', and hybrid organizations' use of these programs. Without such support, the adoption of the hybrid structure will likely be limited.

As per pre-budget recommendations Imagine Canada has consistently made to the House of Commons Standing Committee on Finance to encourage earned income activity by charities, expansion of these programs to make charities eligible (where they are not currently) remains a top priority. If innovative public policies are to achieve the desired goals, organizations working in the sector require access to the advice and expertise on offer by these federal business development programs so that they can develop the capacity to take advantage of new opportunities. We were encouraged by the measure in the 2014 federal budget to remove barriers to charities' eligibility under the Mitacs program, which we see as a promising beginning in this regard.

2. *Should a decision be made to proceed with a hybrid structure, the federal government should reiterate its commitment to philanthropy by working to ensure that any investment incentives associated with a new hybrid structure do not negatively affect Canadian philanthropy.*

Discussions of the utility of socially responsible enterprises invariably involve discussions of complementary investment incentives and tax credits. Incentives, for example, are required to attract investment as they compensate the investor for the lower rates of return afforded by investments in the hybrid structure (due to dividend and interest caps) over investments in conventional corporations. Without special tax incentives, the new hybrid structure is merely a branding vehicle and its take up will likely be curtailed.

However, incentives to encourage investment in new hybrid structures may cannibalize the funds available to charities. For example, will investors divert funds from their existing investment portfolios to invest in hybrid corporations? Or, will investors perceive their investment as philanthropic, since its potential yield is capped, and therefore donate less to charities? If the donations passed on from the hybrid organization are higher than philanthropic losses, individual charities that are able to take advantage of a hybrid structure may still benefit overall. There remains a risk, however, that even if the net financial impact for the sector as a whole is positive, resources may shift from one portion of the sector to another creating a new set of challenges. Without further analysis we can only speculate as to what these effects might be. Both the intended and unintended effects on philanthropy should be assessed prior to introducing investment incentives intended to support a new hybrid structure.

Recent data released by Statistics Canada show that both the *total amount donated* to charities by tax filers and *the number of people* reporting donations fell in 2012 from 2011 levels. These figures are indicative of a worrisome trend affecting the philanthropic base on which so many charities, and their communities, rely. The importance of philanthropy also extends beyond its monetary value. We know that there is a strong correlation between donating and volunteering. Thus, measures that negatively affect donations could also lead to lower levels of volunteerism in communities.

Imagine Canada is concerned with any policy that could negatively affect Canadian philanthropy. The federal government should ensure that any accompanying investment incentives to a new hybrid structure will complement and reinforce the existing suite of federal government measures intended to facilitate Canadian philanthropy.

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3. *Should the Canada Business Corporation Act be amended to facilitate the creation of hybrid organizations, the federal government should establish a regulator of hybrid organizations with both the capacity and the investigative and enforcement powers to ensure compliance.*

   By establishing a hybrid structure, the government would legitimize and endorse it as a new brand of company with a social purpose. As a result, the hybrid structure would enjoy significant 'brand lift' in that it would be associated with the broader social good sector that has developed an established reputation of trust and goodwill. Any abuse of the new hybrid structure would have the potential to reflect negatively on the entire social good sector. Charities, which represent a significant portion of the social good sector, have a vested interest in the integrity of a new hybrid corporate form for this reason.

   While dividend caps, asset locks, and reporting requirements are laudable measures, they are only effective to the extent that they are enforced. Consideration of a new hybrid structure should be accompanied by attention to how that structure will be regulated. A regulator should be established to actively review the registration of new hybrid organizations to ensure they meet the community interest test. The regulator should also be established with both the capacity and the investigative and enforcement powers to ensure compliance. The need for a strong regulator is further exacerbated by the potential use of public funds in the form of tax incentives that would likely accompany a new hybrid structure, as has been the case in other jurisdictions. With public funds at risk, it is imperative that enforcement and compliance be high priorities.

Conclusion

Our communities are best served when charities and nonprofits, governments, and private businesses work together for public benefit. A new hybrid structure is one potential way the government could facilitate this work and we are encouraged that it is consulting with Canadians on how best to do so. However, we feel that the scope of the consultation as designed may be too narrow for the magnitude of the issue at hand. As it stands, the section of the consultation dealing with socially responsible businesses is one of twenty issues on which Industry Canada is soliciting feedback. It is unlikely that the issue will receive sufficient attention and analysis within this context. As with all things, the devil is in the details. It is crucial that the government consider the broader regulatory and policy implications, including the effects on philanthropy, associated with a new hybrid corporate structure as well as how the structure itself complements the existing suite of incorporation options.

Imagine Canada would be pleased to meet with you to discuss the foregoing recommendations, and I will ask my office to follow up with you in this regard. Thank you in advance for your consideration of our views; I look forward to hearing from you soon.

Yours truly,

Cathy Barr

President & CEO (Acting)