

**The new regulatory regime
for social enterprise in
Canada: potential impacts
on nonprofit growth and
sustainability**

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Executive Summary

Social enterprises are organizations that operate in the marketplace as a business, but pursue social, cultural, environmental or societal goals. They range from charity for-profit subsidiaries, to non-profits, to low-profit for profits pursuing social purposes. Increasingly, this group of new and old organizations that blend business with social goals is being seen as a distinct new “identifiable and viable organizational form” (Elson & Hall 2010). The boundaries of this new form are still being solidified; this report will include as ‘social enterprise’ organizations that exclusively or primarily pursue social goals, as well as low-profit for-profit businesses with largely social purposes (now often called *social purpose businesses*).

Social enterprise appears to have grown rapidly in Canada in recent years, and this growth is expected to continue. This report increases our understanding of the impact of Canada’s evolving legal framework for social enterprises on the future development of social enterprise in Canada. Its main focus is the very new social enterprise-specific legal forms in British Columbia and Nova Scotia and their progenitor, the U.K. Community Interest Company (CIC). But it also examines how well the other legal forms used by Canadian social enterprises meet their needs, especially in light of recent changes. The report is primarily based on a literature review of refereed and grey literature, supplemented by interviews with several Canadian social enterprise experts.

Canadian social enterprises currently use a variety of legal forms, almost none of which were designed for organizations that operate businesses to achieve social ends. Most social enterprises appear to be non-profits and charities. The report’s first finding (Section 2), not surprisingly, is that existing forms by and large are not a great fit for social enterprises, particularly in financial terms. Legal forms that allow unrestricted business activity and profit-making make it more difficult to pursue social ends (e.g. for profit companies), while legal forms designed for organizations with social ends (e.g. non-profits and charities) provide only limited opportunities to earn business income and raise financing. Recent regulatory changes in particular have reduced non-profits’ potential to generate revenue, on paper at least. Charity and non-profit social enterprises find ways around the limits on earning business income, but at considerable cost and effort. Moreover, the regulatory regime for the non-profit and charitable sectors as a whole is considered incomplete and inadequate.

Similar new legal forms introduced B.C. (the *Community Contribution Company (C3)*) and Nova Scotia (the *Community Interest Company (CIC)*) in 2012-13 build the social enterprise’s social purpose into its legal structure, while allowing the social enterprise to operate as a regular for-profit business in terms of finances, governance and administrative burden (Section 3). They are intended to complement, not replace, current legal forms for social enterprises. Dividend caps and other asset and income locks build the CICs/C3s’ social purposes into their legal structure, as well as the requirement in law to serve a community purpose and to report annually on how this has been done. CIC/C3s are taxable companies and receive no special tax benefits, as

yet. Government and many legal and social enterprise experts expect the C3s/CICs to give social enterprises with broader non-charitable purposes (charities cannot be C3s or CICs) the scope to generate internal revenue via profits, and to provide much-needed access to equity and commercial loan financing, as well as a 'brand' that flags their social purposes. With their social purpose 'brand', they are also touted to become the preferred legal vehicle for charities' and non-profits' profit-making subsidiaries.

The U.K.'s experience with its pioneering Community Interest Company (CIC) sheds light on the potential impacts of the C3s and CICs on Canadian social enterprise. Introduced in 2005, the U.K. CIC was intended to address two main problems facing U.K. social enterprises: first, the near absence of a legal form for social enterprises that would secure their social purposes in law, and, second, the perceived need of social enterprises to access new forms of financing, especially equity financing (Section 4). The first problem arises from the absence in U.K. law of North America's non-profit corporation, which is designed explicitly for organizations with social purposes, and which in law 'locks' non-profits' income against distribution into private hands. Only charities in the U.K. are completely asset-locked, in terms of both income and assets.

The second problem is, as in Canada, the growing financial pressure on the U.K. not-for-profit sector (the 'Third Sector', which includes charities) to raise more income through 'trade', and the stated need for social enterprise to access new forms of financing, including equity financing.

The U.K.CIC's legally innovative dividend caps and other social purpose legal requirements, has been designed primarily for social enterprises with broader, non-charitable social purposes that seek a legally secure social purpose 'brand' and better access to financial resources, including largely social investment equity. An additional policy agenda for the government was to create a legal vehicle to facilitate the contracting out of government service delivery, and the 'spinning-out' of formerly public services, such as the National Health Service, without fully privatizing them.

The success of U.K. CICs has been mixed (Section 5). Take-up has been high relative to other European legislative innovations, with most of the interest coming from Third Sector organizations (charities cannot be CICs) in health, education and social services, the 'heartland' of the U.K.'s Third Sector and Canada's non-profit sector. But only 12% of CICs registered to date are incorporated as regular share corporations, legally allowed to raise equity finance and issue dividends. This is a far smaller proportion than the government had hoped. (Another 10% are share corporations that can only pay dividends to other asset-locked bodies, and therefore likely to be trading subsidiaries)

CICs in the Third Sector also appear to be as dependent on government for income as charities and other social enterprises, reflecting in large part, commentators suggest, the government's success in outsourcing public service delivery and 'spinning-out' public services into Third Sector hands. CIC status does not appear to have given Third Sector CICs much of an

advantage in the competition for grants and other traditional funding, or increased their access to or use of loan financing, which remains relatively low. However, the CIC structure is seen to make it easier for charities to trade while protecting the social purposes of the charity and of the CICs.

To make the CIC model more attractive to for-profit social enterprises and social investors, the government has twice raised the CIC's dividend caps since 2005, most recently in 2013. It has also invested in developing the social investment market.

What might Canada learn from the U.K. experience? The Third Sector's high take-up of CICs suggests that U.K. CICs may be filling the Third Sector need for a legal form that securely protects its social purposes (Section 6). Some of this take-up is driven by the Third Sector's response to the U.K. government's new government outsourcing and 'spinning-out' policies. But Canada already has the non-profit legal form, which legally protects organizations' social purposes. (Provincial laws vary on the distribution of assets at dissolution). This said, Canada's regulatory regime has made it increasingly difficult for non-profits to generate revenue internally to use to grow the organization, and their external financing options are also limited. Yet again, non-profits are tax exempt while CIC/C3s are taxable corporations. It remains to be seen whether some new social enterprises find the C3/CIC form more appealing than the traditional non-profit legal form.

The U.K.s' experience with CICs as a vehicle to open up equity financing to social enterprises has proven disappointing so far. The U.K. experience does not bode well for Canadian C3s and CICs on its face, although much depends on the state of social investment markets, and on social enterprises' readiness for investment, in the two countries. In addition, the B.C. C3s' dividend cap (40%) is set somewhat higher than even the new U.K. cap (35%), and its cap may have reached just the right threshold. (Nova Scotia has yet to issue regulations specifying the caps for its CICs.)