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

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Section 1: Introduction to Social Enterprise

Social enterprises are organizations that operate in the marketplace as a business, but pursue social, cultural, environmental or societal goals. Since the concept of 'social enterprise' first emerged 30 years ago (DeFourny & Nyssens 2010), the term has come to be applied to a group of widely heterogenous organizations. However, they all sit at the junction of the nonprofit and for-profit sectors. Some of the types of organizations now called social enterprises existed well before the term 'social enterprise' was conceived – Canada's Canadian Goodwill Industries, for example. Increasingly, however, the 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).

Social enterprise has grown rapidly in Canada in recent years, and its growth is expected to continue. This report aims to increase our understanding of how Canada's evolving legal framework for social enterprises is affecting, and is likely to affect, the future development of social enterprise in Canada. Its main focus is the new legal forms, specifically designed for social enterprise, that have been recently introduced in Canada.

1.1 Social Enterprise in Canada

What counts as a social enterprise? The boundaries of this new organizational form are still fluid, with most current social enterprise literature still focused on definitional debates (Short, Moss & Lumpkin 2009). One important scope issue, for example, is whether social enterprises exclusively or principally pursue social, cultural or environmental goals, or whether profit-seeking can also be a legitimate goal. Early definitions excluded profit-seeking as a goal (Teasdale 2010; OECD 1999; OTS 2006; Dees 2001), but at this point the definitions usually include low profit for-profit enterprises, and now, primarily in the U.S., corporations that seek significant profits as well as social ends (e.g. BMG 2013; McIsaac & Moody 2013; Alter 2007; DeFourny & Nyssens 2012). Low profit for-profit enterprises are increasingly distinguished from not-for-profit social enterprises by calling them '*social purpose businesses*' (e.g. Malhotra et al 2010). Socially responsible for profit corporations are also sometimes considered social enterprises (Fruchterman 2011; Kelley 2009), but will not be included in this discussion. Enterprises do not need to earn all their income through business activity to be called social enterprises – a minimum 25% of income earned through business is a common criterion (e.g. BMG 2013).

The debate over the boundaries of 'social enterprise' expresses a substantive debate about the role that socially-driven business enterprises should play in our society, and through that, what kind of society we should create. Conceptions of social enterprise also shape policies, laws and funding regimes aimed to promote social enterprise.

On the ground, social enterprises are a heterogeneous group, even excluding socially responsible for- profits. They include non-profit operators of community, cultural or environmental enterprises that build their community or address urgent societal issues such as climate change and pollution; for-profit corporations pursuing similar ends; charities operating businesses that directly support their charitable goals – such as running businesses that provide jobs for highly disadvantaged populations, or individuals with disabilities, as well as providing training and other supports; arms-length subsidiaries of charities or, less often, non-profits, that generate profits for the parent organization; and traditional cooperatives. They can be created by existing organizations or collectives of individuals, or can be created and run by individual social entrepreneurs. They can be operated as projects or programs within existing organizations, as arms-length subsidiaries, or can exist as independent organizations.

Canada's social enterprises are still being mapped. Recent surveys of non-profit social enterprises in several provinces have found that about half of these enterprises were charities (58% in Ontario). Most served vulnerable and marginalized populations, many helped highly disadvantaged populations reintegrate into the labour market. They did this by providing them with jobs, training, and other supports(Elson& Hall 2010; O'Connor et al 2012, Flatt et al 2013; Tarr & Karaphillis 2011).[1]

Nearly all the social enterprises surveyed in each province (70-80%) said they had a social mission, and large minorities had an environmental[2] or cultural mission[3] (Elson& Hall 2010; O'Connor et al 2012, Flatt et al 2013; Tarr & Karaphillis 2011). About one third to one half (34-47%) of respondents, depending on the province,[4] reported that generating income for a parent organization was a goal, although only 12-20%, depending on the province, said it was their sole goal (Flatt et al 2013; O'Connor et al 2012). Many of the Ontario social enterprises surveyed reported being part of a larger nonprofit/charitable organization. This was particularly true for social enterprises focused on alleviating poverty (just over two-thirds of all the social enterprises surveyed). Nearly two thirds of Ontario poverty-alleviating social enterprises (60%) were part of a larger organization, most of these operated as in-house programs, rather than as arms-length subsidiaries (Flatt et al 2013). Nearly all thrift stores (88%) had a parent association (Flatt et al 2013).

[1] Some 71% of respondent organizations in Nova Scotia reported this types of business activity (Tarr & Karaphillis 2011). In the west, the percentage ranged from 22% Alberta to 51% (B.C.), and 31% in Manitoba. In Ontario it was just over 40%.

[2] Between 22% (Alberta) and 46% (Manitoba) of social enterprises cited an environmental mission (Elson& Hall 2010, O'Connor et al 2012, Flatt et al 2013).

[3] Except in Manitoba where 68% reported this (O'Connor et al 2012).

[4] B.C., Alberta, Manitoba and Ontario

In each of the provinces surveyed, most of the social enterprises reported receiving some government funding,[5] and many (at least 41% in each province surveyed) received funding from private individuals, philanthropists (individual and foundations) and donors. Social enterprises focused on alleviating poverty were most likely to receive government grants, but 70% of their income came from sales of goods and services, including service contracts with government (Flatt 2013). Foundations were also significant funders for social enterprises in every province surveyed, but few social enterprises received financing from commercial banks or credit unions, except in B.C., where 26% of social enterprises received funding from this source (Elson& Hall 2010; O'Connor et al 2012; Flatt et al 2013; Tarr & Karaphillis 2011).

Social enterprises operate in a variety of sectors. The recent survey of Ontario social enterprises found most were concentrated in retail sales (including thrift)(36%), education (27%), landscaping/gardening(20%), food services/catering(19%), janitorial/cleaning services(17%), tourism (16%), and sports and recreation (15%) (Flatt et al 2013).

1.2 Why Social Enterprises?

Our current knowledge of Canadian social enterprises suggests several reasons for the growth in social enterprise. One is the search for financial sustainability by existing non-profits and charities already pursuing social ends, but looking increasingly to business ventures (in house or arms-length) to finance their existing activities. Another is the creative use of business activities by non-profits and charities to achieve their social ends – operating restaurants and other businesses that employ the highly disadvantaged is an example of this. A third is the attempt to harness market forces to work to achieve new, urgent social goods, such as eliminating climate change or environmental degradation, or preventing community degradation. These social goods are perceived to be beyond the scope of government or the private sector to achieve, or at least to be social goods that neither government nor the private sector are making significant effort to achieve, or to be social goods that by their nature require market-based solutions.

The differing motivating reasons for creating social enterprise create different policy challenges. Outside the non-profit and charity sectors, the debate and optimism about social enterprise in Canada tends to be focused on social enterprises driven by the third motivating reason. As the Canadian Task Force on Social Finance recently stated:

"[We] have long relied on governments and community organizations to meet evolving social needs, while leaving markets, private capital and the business sector to seek and deliver financial returns. However, this binary system is breaking down, as profound societal challenges require us to find new ways to fully mobilize our ingenuity and resources in the search for effective, long-term solutions. Mobilizing

[5] For example, 69% in Alberta, 47% in B.C., 60% in Manitoba, and more than 85% in Nova Scotia.

private capital to generate, not just economic value, but also social and environmental value, represents our best strategy for moving forward. (Canadian Task Force on Social Finance 2010, p. 1)"

These social enterprises may be nonprofit or for-profit, and are often initiated by individual social entrepreneurs. Some funders call for-profit organizations in this group 'social purpose businesses' [6], but this study will include them as social enterprises. For this loose group of social enterprises, as for social enterprises in the non-profit and charity sectors, access to financial resources is a major issue (Bridge & Corriveau 21010; Bridge 2010; Weber& Geobey 2010; Mulholland et al 2011; Treurnicht 2011; McIsaac & Moody 2013; Rajotte 2009; Malhotra t al 2010; Flatt et al 2013).

1.3 The Legal Framework

Social enterprise is fairly new to Canada, at least in its present guise, and relatively little is known about the sector or the forces shaping its growth, fields of activity, and financial sustainability. The regulatory environment is one potentially important factor shaping the growth and development of Canadian social enterprise. Until recently, Canada has had only one social enterprise- specific legal form – the cooperative – and social enterprises therefore use a variety of legal forms designed for other purposes, such as the non-share capital (non-profit), and share capital corporations(e.g. Bridge & Corriveau 2009). Within the last year or so, however, British Columbia and Nova Scotia have introduced similar new legal corporate forms specifically for social enterprises, Community Contribution Companies (C3s) and Community Interest Companies (CICs), respectively. Both are modeled on the Community Interest Company (CIC) introduced in 2005 in the U.K.[7]

This report examines recent changes in Canada's evolving regulatory environment as they affect, or are likely to affect, the growth and development of Canadian social enterprise – specifically their growth, the fields in which they operate, and their financial sustainability. The report's main focus is on the new social-enterprise specific legal forms. About these forms the report asks: What kinds of social enterprises are they intended to support? What are they likely to achieve? And how will they affect the attractiveness of other legal forms to social enterprises?

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[6] See, for example http://www.marsdd.com/articles/social-purpose-business-spb-models/. Also Malhotra, A., Laird, H., & Spence, A. (2010). *Social finance census 2010: A summary of results from the social finance census of nonprofits and social purpose businesses*. Toronto, ON CAN: Social Venture Exchange and Ontario Nonprofit Network. Retrieved December 15, 2013 from, http://www.socialventureexchange.org/docs/sfcensus2010.pdf.

[7] *Companies (Audit, Investigations and Community Enterprise) Act (2004, c.27)*. Retrieved from Government of UK website: http://www.legislation.gov.uk/ukpga/2004/27/pdfs/ukpga_20040027_en.pdf

The report also looks at the real and potential impacts of recent changes to the other legal forms used by Canadian social enterprises. Section 2 discusses these legal forms, and how well they appear to serve social enterprises, and may continue to serve social enterprises. Section 3 describes the new legal forms in B.C. and Nova Scotia, and what they hoped to achieve.

Since it is far too early to assess the impact of B.C.'s and Nova Scotia's new legal forms on social enterprise in their provinces, the U.K. experience with its CIC model can shed light on the impacts they may have here. The U.K. experience with CICs is examined in Sections 4 and 5. Differences between the U.K. and Canadian legal, funding and policy contexts are noted, because these could influence the impact of the Canadian legal forms on social enterprise here.

1.4 Methodology

The research on which this report is based is primarily a literature review of refereed journal articles, government documents, charity lawyer blogs and other grey literature that document and analyse the changing regulatory frameworks for social enterprises in Canada and the U.K.. The literature review of the Canada's regulatory framework, and of recent changes to the framework, is supplemented by a handful of interviews with experts in the field. Their comments on the legal context for social enterprise in Canada, and the potential impact and value of recent legal innovations here, are integrated into Sections 2 and 3.

Section 2. The Legal Regime for Canadian Social Enterprises

Canadian social enterprises use a variety of legal forms, almost none of which, until very recently, were designed for social enterprises. Instead, existing legal forms used by social enterprises largely reflect the fundamental split between organizations designed to serve the social good/social or community purposes, and organizations designed to maximize private profit. How well do these legal forms suit hybrid organizations like social enterprises, which have social ends but use market-based means? This section describes the most common legal forms used by Canadian social enterprises prior to introduction of the new B.C. and Nova Scotia laws, and examines their fit for social enterprise in terms of legal eligibility, pursuit of social ends, acquisition and use of financial resources (especially profits), governance, and administrative burden. In addition, it describes recent regulatory changes in these legal forms that affect social enterprises, and assesses their impact on social enterprises that adopt these legal forms.

2.1 Non-Profits

The non-profit corporation[8] is a popular legal form for Canadian social enterprise, and the legal form used by incorporated charities, which are discussed later. Non-profits are largely incorporated under provincial company law, but their tax status is governed by federal tax law. Provincial incorporation laws vary[9] significantly, but all define a non-profit as an organization that does not distribute income or assets to the personal benefit of members (including private investors/shareholders)[10]. This is called the non-distribution rule. Non-charitable non-profits' tax status is governed by Section 149 (1)(l) of the *Income Tax Act* [ITA]. [11] Tax law also requires non-profits not to distribute income, and to meet other criteria, to be tax exempt.[i] (These other criteria do not always align with provincial incorporation laws for non-profits).[12] Non-profits meeting *ITA* criteria are exempted from federal income and some other taxes (CRA 2001).

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[8] Provincial incorporation laws refer to these organizations as 'societies' or 'corporations without share capital'.

[9] A small number of Canadian non-profits are incorporated under federal non-profit incorporation law.

[10] See for example, the provisions of Ontario's *Not-for-Profit Corporations Act* (2010). A guide to the ONCA is available at http://www.sse.gov.on.ca/mcs/en/Pages/onca7.aspx

[11] Canada Revenue Agency. (2001). IT-496R, *Income tax act: Non-profit organizations*. Retrieved September 11, 2013, from, http://www.cra-arc.gc.ca/E/pub/tp/it496r/it496r-e.html. For the *Income Tax Act,* see http://laws-lois.justice.gc.ca/eng/acts/i-3.3/page-261.html#h-87

[12] Section 149(1)(l)'s criteria for eligibility for tax exemption are: the non-distribution rule; the requirement that the organization operate exclusively for the purpose for which it was organized; the requirement that the non-profit is not a charity; and the requirement that the organization operate 'exclusively for social welfare, civic improvement, pleasure, recreation, or for any other purpose except profit' (CRA 2001).

One of the *ITA* criteria for tax exemption highly relevant for social enterprises is that the organization operates 'exclusively for social welfare, civic improvement, pleasure, recreation, or for any other purpose except profit'. Since the *ITA* does not define 'any other purpose except profit', this task has been left to Canada Revenue Agency (CRA) to interpret and its interpretation has changed over time.

The regulatory framework for non-profits, including incorporated charities, is generally agreed to be inadequate for all non-profits. It has been described as a "mish-mash of federal and provincial statutes and regulation", each with its own different rules, many of which non-profits routinely ignore or set up complex structures to bypass (Chenier 2012; Bridge & Corriveau 2009). Nonprofit social enterprises are also therefore subject to this 'mish-mash.'

2.1.1 Operating a Business

Social enterprises operate businesses. Both incorporation and tax laws governing non-charitable non-profits (charities are subject to different tax laws) regulate if and when non-profits may operate businesses, and if they can make any profits (though, as already stated, none of these laws permits distribution of profits). Provincial incorporation laws vary considerably on these two issues. They range from a prohibition on non-profits operating any business (Nova Scotia (Bridge 2010) and Alberta (Chenier 2012[13])), to permission to operate a business, and to make profits where the profits are used to advance the organization's non-profit purposes (New Brunswick, Saskatchewan, Quebec, Manitoba[14], Ontario[15]) (Jamieson et al 2011). In between, British Columbia's *Society Act* allows business activities as long as they are incidental to the organization's activities, and the business is not run for the purpose of profit[16] (Jamieson et al 2011). The new federal *Canada Not-for Profit Corporations Act* provides no explicit guidance on this issue to non-profits incorporating under federal law (Bridge 2010.)[17] Where provinces do permit non-profits to operate a business, they may also limit the types of business that the non-profit can pursue.[18]

[13] Alberta non-profits incorporated under the Alberta Societies Act are prohibited from operating any business. Alberta non-profits incorporated under the province's Companies Act may operate a business.
[14] *Corporations Act (Manitoba)* (2010, c. C225). Retrieved September 13, 2013 from Province of Manitoba website: https://web2.gov.mb.ca/laws/statutes/ccsm/c225_2e.php
[15] Permitted under the soon-to-be-proclaimed *Ontario Non-Profit Corporations Act (ONCA)*. Available at: http://www.e-laws.gov.on.ca/html/statutes/english/elaws_statutes_10n15_e.htm
[1616] See: http://www.bcregistryservices.gov.bc.ca/bcreg/corppg/societies/faq.page?#soc-for-profit/q
[17] Provincial laws also vary in the restrictions they place on how non-profits may generate non-business income. In Nova Scotia, for example, prohibits non-profits from generating revenue by from fees for core services, unless those services are delivered 90% by volunteers (Bridge 2010)
[18] *Corporations Act (Manitoba)*. Op.Cit.

Non-profit social enterprises that run businesses and make profits may therefore run afoul of their provincial incorporation laws, even when they use the profits to sustain the business and obey the non-distribution rule.

Federal tax law allows non-profits freedom to operate a wide range of businesses, as long as the purposes are not charitable, in which case they are expected to register as charities (BCCSE 2013). But, crucially for social enterprises, federal tax law does limit non-profits' freedom to make profits from their businesses. The CRA rules permit some surplus revenue as long as the use of resources is reasonable and excess income is not greater than the reasonable needs of the organization (CRA 2001; Mason & Blatchford 2011). And income from investments is generally permitted (CRA 2001; Mason & Blatchford 2011). But the CRA severely restricts non-profits' ability to accumulate and use large revenue reserves, except for specified capital purposes,[ii] and it views non-profits that do accumulate reserves inappropriately as having for-profit intent (CRA 2001; Drache 2013).

These restrictions limit non-profit social enterprises' ability to accumulate reserves to use in growing the organization (Broder 2010). They also give non-profit social enterprises less collateral to offer banks when securing operating loans (Broder 2010).

Recent Developments

More important for non-profit social enterprises, however, is the CRA's interpretation of its criterion that non-profits can operate for '…any other purpose except profit'. Prior to 2009, the CRA permitted non-profits to make (modest) profits as long as the profits were used to support the organization's social mission (the destination rule) (CRA 2001). Since 2009, however, the CRA has allowed non-profits to make only 'incidental and unintended' profits (CRA 2009). The CRA outlined its position in an Opinion Letter:

> *"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 incurred" (CRA 2009).*

The examples of 'incidental and unintended' profits provided in the letter rule out even mid-year mark-ups in which the extra income is spent by year-end (Corriveau 2010). Moreover, where 'unintended profits' are necessary for the organization's survival, the non-profit is viewed by CRA as having a profit purpose (CRA 2009; Blumberg 2013). [iii] Non-profits that violate the CRA's new interpretation of the ''…except profit' clause risk losing their tax exemption.

This said, some experts say that the Opinion Letter does not actually reflect the CRA position (Elson)[19]. They also suggest that the current CRA position is not supported by case law (Mason & Blatchford 2011), in which case non-profits could challenge CRA rulings in court. Moreover, there are no reported cases of where a non-profit has lost its status because of profit accumulation (Drache 2013).

However, the new CRA position is widely seen to significantly inhibit non-profits' ability to finance growth, and to subsidize their money-losing activities or programsthrough their business profits (e.g. Bridge 2010; Broder 2010; Manwaring et al 2011). This inhibition would equally apply to non-profit social enterprises. Canadian social enterprise non-profits (and non-profits generally) already have limited avenues for raising money. The non-distribution rule makes them relatively unattractive to conventional investors, since they cannot reward them, with the result that they are rarely able to access private investor capital to fund their activities and to grow their organization. Non-profits can also solicit donations, but they cannot issue tax receipts like charities (CRA 2001). Nor can they access funding from private foundations, as charities can (CRA 2001). Nova Scotia is an exception among the provinces in supporting non-profits through tax breaks; it provides a 35% tax break for contributions to qualifying corporations, co-operatives and community economic development initiatives (Bridge 2010).

Non-profits most often rely on loans for external financing. A recent survey of Ontario social enterprises found that non-profit social enterprises used debt financing more than other non-profits, but use was still low: lines of credit (26%), bank loans (19%), and community bonds (2%) (Malhotra et al 2010).

The non-profit sector may not have felt the full impact of the new CRA rules on making profits, because the CRA estimates that about 75% of Canadian non-profits are currently in violation of its 2009 Opinion Letter (BCCSE 2013).

2.1.2 Arms-Length Subsidiaries & Other Options

One legally available option for non-profit social enterprises to generate revenues is to set up arms-length subsidiaries to generate profits for the parent organization. These subsidiaries are typically for-profit corporations. The CRA appears to permit this on a case by case basis,[20] but non-profits setting up such subsidiaries must be careful that by doing so they do not signal an

[19] Personal Communication with Peter Elson, senior research associate, Institute for Non-profit Studies, Mt. Royal University.

[20] The CRA indicated recently that by incorporating a taxable subsidiary, a non-profit does not necessarily jeopardize its tax exemption, and that permission would depend on the facts of the case (Drache 2012; Robertson 2013; Valentine 2013; CRA 2012a). In other recent technical interpretations of specific cases, the CRA had stated the view that non-profits using 'excess' funds to purchase and make loans to a taxable subsidiary would be viewed as having a profit motive, since the non-profit clearly had amassed more funds than needed to do its non-profit work (Man 2013).

intent to make a profit (BCCSE 2013; Drache 2012; CRA 2012a). If the non-profit can set up a subsidiary, up to 75% of the profits from the subsidiaries can flow back to the non-profit, the limit the CRA allows for profit corporations to donate to non-profits and charities (Randall 2013).

The CRA does not allow non-profits to use their own resources to set up a subsidiary through, say, loans to the enterprise (Drache 2012, 2013).

Another choice for non-profits incorporated in provinces with incorporation laws permitting non-incidental profits, is to operate their businesses at a profit and forfeit tax exempt status.

2.1.3 Conclusion

While nearly all Canadian provinces allow social enterprise non-profits to operate, many provinces require their businesses to be secondary to other activities, and strictly limit their ability to generate profit income. Since 2009, federal tax law has also severely limited their ability to generate profits, even where these are ploughed back into the social enterprise. The recent CRA changes in particular, are widely thought to reduce the attractiveness of non-profit status for social enterprises, since they appear to effectively close one important avenue for generating revenue to grow the organization, or for the organization to cross subsidize money-losing activities with income from profitable activities (Bridge 2010). Only one province to date has established tax breaks to increase access to equity financing. The situation for non-profit social enterprises is complicated by evidence that many Canadian non-profit social enterprises are violating one or both of their provincial incorporation laws and federal tax law (BCCSE 2013). Many non-profits have traditionally failed to file required tax documents (even when tax exempt) and ignored requirements (e.g. Mason & Blatchford 2011).

Non-profit incorporation has a relatively low administrative burden for social enterprises, and permits a fairly wide range of social but non-charitable purposes. However, its governance requirements may also deter social entrepreneurs who want to both run and direct their enterprises. Directors of non-profits cannot typically be remunerated. Social entrepreneurs must therefore choose between directing the organization for no remuneration, or managing the organization for remuneration, but with loss of control (Bridge & Corriveau 2009).

2.2 Charities

Charities may be unincorporated, or they may incorporate as non-profits. About 86,000 of Canada's estimated 161,000 non-profits are charities.[21] In the absence of provincial or federal charity laws (except in Ontario), Canadian charities are effectively governed by federal tax law

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[21] Information retrieved December 3, 2013 from Imagine Canada at: http://www.imaginecanada.ca/node/2420.
In 2008, there were 83,000 registered charities in Canada, according to the CRA (CRA 2008).

administered by the CRA's Charities Directorate (Bridge & Corriveau 2009; Carter & Man 2009). The CRA has come to dominate regulation of Canadian charities in large part because of the absence of provincial (and federal) charity laws (Aptowitzer 2009; Mulholland et al 2011).[22] The resulting somewhat ad hoc regulatory framework for charities is widely agreed to have bred gaps and confusion for charities (e.g. Mulholland et al 2011), over and above the 'mish-mash' of provincial non-profit incorporation laws under which many charities incorporate (Bridge & Corriveau 2009).

The CRA's Charities Directorate closely regulates charities, making their administrative burden high. The CRA's strict constraints on charities create difficulties for social enterprise charities, although the CRA does allow social enterprises to operate as charities. However, the types of social enterprises eligible to become charities is limited by the narrow range of purposes permitted charities,[23] the public benefit test they must meet,[24] and other general requirements of charities.[25]

Charitable social enterprise charities are also more restricted than non-charitable non-profit social enterprises in how they can use their income and assets. Charities' income is subject to the non-distribution rule (CRA 2008), and thus they cannot raise equity financing. Their assets are also locked -- that is, cannot be distributed to the personal benefit of members -- when the charity dissolves. For example, when a charity dissolves or reverts to simple non-profit status, it must either pay the CRA 100% tax on its profits, or gift those assets to a *qualified donee*[iv] such as another charity, foundation, or a municipality (see below) (Corriveau 2010). By contrast, some provincial laws do not lock non-profits' assets at dissolution or conversion,[26] but allow them to pass into private hands (Blumberg 2013). Charities are also required to spend a minimum of 3.5% of their investment assets a year on their charitable activities[27]. These measures are designed to ensure that charity resources are used for charitable purposes, but they reduce financial flexibility for charitable enterprises.

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[22] Other provincial laws such as fundraising rules in Alberta and the registration of a charity in Quebec also apply to charities (Aptowitzer 2013), and thus affect their activities.
[23] Charities must pursue one or more of these purposes: relief of poverty, advancement of education, advancement of religion, and other purposes beneficial to the community in a way the law considers charitable (CRA 2008).
[24] The public benefit test requires that the organization provide tangible benefits to the public, and that these benefits must be made available to a sufficiently large section of the population so as to be considered a public benefit (CR 2008).
[25] In addition, charities must devote substantially all their resources to charitable activities carried on by themselves (CRA 2008). At common law, in addition, they must have 'exclusively and legally charitable' purposes.
[26] Ontario's soon-to-be-proclaimed *Ontario Non-profit Corporation Act*, for example. ONCA. Op.Cit.
[27] See <http://www.cra-arc.gc.ca/chrts-gvng/chrts/prtng/spndng/menu-eng.html.>

Further, while charities are allowed to operate businesses (see below), these businesses are not expected to be a major revenue source for the charity, or to consume more than a minor portion of the charity's attention and resources (CRA 2003).

The primary benefit of charitable status is its tax entitlements. Charities receive tax exemption on their income, and they can raise income from individual and corporate donations by issuing tax receipts to donors (CRA 2008). Corporations can donate up to 75% of their income to a charity (Randall 2013; Corriveau 2010; CRA 2003). Charities are also eligible to receive funding from foundations and other charities (Corriveau 2010). Charities can also raise money through debt financing, grants, investments, and commercial activity.

2.2.1 Operating a Business

Charities have been allowed to operate businesses since 1976 (Carter & Man 2008), but the range of business activity permitted by the CRA is narrow.[28] The CRA defines 'business' in general terms as any commercial activity – deriving revenues from providing goods and services – undertaken with the intention to earn profit (CRA 2003). In brief, the CRA permits a specified, limited range of commercial activities which it does not consider 'operating a business'. [29] These include charging fees, where the fee charging manifests altruism and public benefit, as in the case of charging fees to offset program costs, (CRA 2003). (However, Nova Scotia incorporation law prohibits either nonprofits or charities from charging fees (Bridge & Corriveau 2009).[30]

Beyond these commercial activities, the CRA allows charities to operate *'related businesses'* operated directly by the charity (Manwaring2012; Carter 2008; CRA 2003) and *'unrelated businesses'* operated at arms-length from the charity.

Since federal tax law does not define 'related business', the CRA has interpreted its meaning, and these interpretations have changed over time. At one point, the CRA viewed a business as related if its profits were used to serve the charity's charitable ends (Manwaring et al 2012). Now, however, it defines *related businesses* as businesses run almost solely by volunteers, or businesses that are 'linked' and 'subordinate' to the charity's purposes.[v] Examples of the former include opportunity shops run by volunteers. Examples of the latter include operating a parking lot, selling items that promote the charity, or selling records of charity events (CRA 2003). Since the

[28] Private charitable foundation cannot engage in business activities (Bridge & Corriveau 2009).
[29] Having the potential to show a profit, or a track record of profits, or being managed by individuals selected for skills that will likely result in profit, may also make a commercial activity a business in the CRA's eyes [CRA 2003]
[30] The CRA permits certain commercial activities that it does not consider to be 'carrying on a business' – for example, selling donated goods, holding specific fundraising activities, receiving income from investments, soliciting donations (CRA 2003; Carter 2008).

related business is part of the charity, it can make profits (Corriveau u.d.) that are tax exempt, and the business can receive donations and issue tax receipts (Corriveau u.d.;CRA 2003). But its profits should go to the charity, rather than to growing the business (CRA 2003; Carter& Man 2008). Related businesses can also share the charity's resources, such as staff and offices, and they are governed by the charity's board.

Highly profitable related businesses are expected to be hived off into arms-length subsidiaries (Corriveau u.d.). These businesses must be taxable corporations (Bridge&Corriveau 2009).They can be non-profits only if the CRA does not consider them businesses (Bridge & Corriveau 2009). Social enterprises that are arms-length subsidiaries of charities have considerably more financial freedom than related businesses run as charity projects. They can make unrestricted profits, and up to 75% of their net profits can be donated to the parent charity tax-free (Corriveau 2010); CRA 2003). They can also retain profits to grow the social enterprise. Charity business subsidiaries can also seek external equity financing and additional business partners (Corriveau u.d.), and the charity is protected from its business losses.

On the other hand, as for-profit enterprises, social enterprise subsidiaries are taxable, and cannot issue tax receipts. So social enterprises lose and gain from moving out of the charity to become arms-length subsidiaries. More intangibly, social enterprise subsidiaries may lose the charity 'brand' they would enjoy as part of a charity, unless the two organizations can be tightly linked through marketing. In fact, most related businesses operated by charities in Canada remain as projects within the charity (Corriveau u.d.), rather than operating as arms-length subsidiaries.

Charities' arms-length subsidiaries must operate completely separately from the charity (CRA 2003), typically having their own board of directors and staff (Corriveau 2010). They cannot share offices or other resources with the parent charity, and cannot buy charity assets at below-market rates (CRA 2003; Corriveau 2010) – since this would amount to a subsidy. The parent charity can retain control of the arms-length subsidiary through either share holdings or nomination of the board of directors (CRA 2003).

Unrelated businesses are charity-owned businesses that do not fit the narrow constraints of related businesses. Charities wanting to run an unrelated business face significant CRA penalties if they do not operate it as an arms-length subsidiary (CRA 2003). Unrelated businesses are also expected to be taxable corporations (CRA 2003; Bridge 2010), and they share the same entitlements and restrictions as arms-length subsidiaries that are related businesses.

Charities can share ownership of their arms-length social enterprises with other charities or external investors (CRA 2003). They can also finance the subsidiary's initial start-up (CRA 2003), as long as the charity can satisfy itself that the investment is a 'prudent use of the charity's assets' (CRA 2003), and it complies with the non-distribution rule (CRA 2003). If the arms-length subsidiary is a partnership, the charity is still considered to be operating a business even if it is the silent partner in the business (CRA 2003).

For charities, arms-length subsidiaries may increase their revenues, while protecting the charity from losses. But they are more complicated to set-up and run than related businesses operated as projects within charities. The Canadian Task Force on Social Finance concluded that arms-length subsidiaries are a costly and onerous solution for charities, and beyond the capacity of many smaller charities to manage (Canadian Task Force on Social Finance 2010). Moreover, arms-length subsidiaries also often put charities in direct competition with traditional businesses that might see this competition as unfair.

2.2.2 Conclusion

While charitable status offers social enterprises enticing financial benefits in the form of tax exemption and the authority to issue tax receipts for donations, its narrow eligibility criteria make it unsuitable for social enterprises which may pursue broader social purposes. Moreover, CRA limitations on charities' freedom to operate businesses – primarily that in-house businesses be 'related' to the charity's purposes, and that they take up a relatively small share of its time and resources – restrict the potential role and scope of charities' business activity. Their alternative is to create arms-length social enterprise subsidiaries, an administrative task beyond the reach of smaller charities, but a potentially lucrative source of income for the charity.

A further drawback of charitable status for social entrepreneurs wanting to own and run their social enterprises is its governance restrictions. As in non-profit corporations, charities cannot pay their directors (trustees), so social entrepreneurs must choose between directing the organization and being paid for their work (Bridge& Corriveau 2009).

2.2.2 Community Economic Development (CED) 'Charities

Social enterprises that would not otherwise be eligible for charity status also receive charity status if their social purposes fit certain CRA-prescribed community economic development purposes (Corriveau 2012). The CRA treats these CED social enterprises as charities because of the specific type of businesses they operate, and the specific types of populations that they serve (Corriveau 2012 (CRA 2012; Corriveau 2012). Many Canadian social enterprises fit into this category (Elson & Hall 2010; O'Connor et al 2012; OECD 2013; Rajotte 2009; Tarr & Karaphillis 2011). It includes, for example, *social businesses* that employ individuals with disabilities (often permanently), and *on-the-job-training* enterprises that provide temporary jobs, training and placement to highly disadvantaged individuals far outside the labour market (CRA 2012).

The CRA's special CED provisions cover businesses and other activities. These CED charitable activities serve four populations: the unemployed, people living in poverty, people living with a disability, and people living in depressed neighbourhoods (CRA 2012). In addition to providing jobs and training to these populations through social businesses and on-the-job-training enterprises, they may also provide loans and grants to organizations serving these populations, such as micro-loans and loan guarantees, or, in economically challenged communities, create services or businesses that provide such things as affordable housing or community facilities.[vi] CED charity businesses may operate as projects within a charity – for example, a café employing psychiatric survivors run by a treatment centre for the mentally ill – or as arms-length subsidiaries of a charity or non-profit. They may also operate as independent businesses, such as Toronto's A-Way courier service which employs psychiatric survivors as couriers. As indicated above, not all CED charity organizations would operate businesses, and therefore social enterprises.

Recent Developments

Social enterprises that qualify as CED charitable businesses pursue broader social purposes than regular charities, but they enjoy similar benefits. Prior to 2012, however, they were not allowed to make profits, even if these were used to support the organization's charitable activities (Corriveau 2012). They were allowed to break-even at best, and social businesses were expected to rely on ongoing funding support (Corriveau 2012; Corriveau 2010). This situation changed in 2012 when the CRA allowed CED charitable businesses to make profits as long as these continue to be 'helping eligible beneficiaries', rather than generating revenue (CRA 2012).

The 2012 CRA guidance announcing the change is also the first CRA directive to use the term 'social enterprise', implicitly equating 'social enterprise' with CED charitable businesses (CRA 2012).

The same 2012 CRA directive also expanded the scope of foundations' Program Related Investments to finance businesses and services for the four specified populations. The aim was to open up more foundation funding to more community enterprises and organizations serving them.[vii]

Summary

The types of social enterprises that fit within CRA's fairly narrow band of 'CED charitable activities' are in the 'heartland' of not-for-profit social enterprise in Canada. Their social purposes are broader than regular charitable purposes, but they serve highly disadvantaged populations and communities. The CRA provisions allow these social enterprises significant financial benefits, while allowing them to generate profits to use in the enterprise, and allowing them to make their businesses their main or sole activity.

Not surprisingly, however, these types of social enterprises – notably *social businesses* and *on-the-job-training* enterprises – are typically not profitable, and rely heavily on government funding (Elson & Hall 2010; O'Connor 2012). The cost of running these social enterprises has been estimated to be 33% higher than for other social enterprises (BCCSE 2013). The new CRA rules on making profits and on PRI investments are therefore likely to help these organizations become more self-supporting, and this may be their intent. The new rules have been warmly greeted by experts in the field (e.g. Corriveau 2012; Man et al 2012).

Like other charities, CED charity social enterprises are subject to the same high administrative burden and governance restrictions (directors cannot be paid) as other charities.

2.2.3 Ontario Restrictions on Charity businesses

Ontario is alone among the provinces in having its own charities law. Its *Charitable Gifts Act* [CGA] was introduced in 1949 to ensure that charitable organizations did not carry on businesses themselves, and to discourage them from putting charitable funds at risk in capital markets (Carter 2009). Two important provisions in the CGA in particular restricted Ontario charities from setting up arms-length social enterprises: the prohibition on their owning more than 10% interest in a business for longer than seven years, and the requirement for charities that did own a more than 50% interest in a business to file annual financial statements of the business and other financial information with the Ontario Public Guardian and Trustee (CGA 1990)[31]. Ontario charities with an interest in a business had to utilize complex organizational structures, such as setting up intermediary for-profit, non-profit corporations or business trusts to work around the CGA's restriction (Carter& Man 2008).

The *Good Government Act* [32] which replaced the CGA in 2009 eliminated these provisions (Blumberg 2009; Carter 2009). It thus removed a barrier to Ontario charities setting up arms-length for-profit businesses to generate revenue for their charitable activities.

2.2.4 The Voluntary Sector and Earned Income

How financially significant are social enterprises to the nonprofit and charity sectors in Canada? The answer is unclear because financial data on the sectors does not appear to disaggregate business revenues from other earned income, which also includes revenue from fees, contracts and investments, as well as other commercial activity. 45.6% of the revenue of the core non-profit sector (that is, excluding hospitals, universities and colleges) was earned income in 2007.[33] Earned income has been rising, both in total value and as a share of core sector revenues;

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[31] *Charitable Gifts Act* (1990, c.8). Retrieved from Province of Ontario website: http://www.e-laws.gov.on.ca/html/repealedstatutes/english/elaws_rep_statutes_90c08_e.htm.

[32] *Good Government Act* (2009, c.33). Retrieved from Province of Ontario website: http://www.e-laws.gov.on.ca/html/source/statutes/english/2009/elaws_src_s09033_e.htm.

[33] Statistics Canada. "Satellite account of non-profit institutions and volunteering." The Daily. December 2109. These figures represent the core nonprofit sector, excluding educational institutions and hospitals. Retrieved January 28 from http://www.statcan.gc.ca/daily-quotidien/091221/dq091221b-eng.htm. See also: (2009). *Satellite Account of Non-profit Institutions and Volunteering.* Ottawa, ON, CAN: Statistics Canada. Retrieved September 23, 2013 from, http://www.statcan.gc.ca/daily-quotidien/101217/dq101217b-eng.htm.

it rose from $3.08 billion to $3.6 billion between 2005 and 2008 (Statistics Canada 2010a) , and its share of total sector's revenues has risen about 42% from 1997 to 2007.[34]

Average donations have also grown significantly (66.6 per cent) since the early eighties, but the donor pool has been shrinking— from 30 per cent of tax filers in 1990 to 23.1 per cent of tax filers in 2009 (Lasby 2007, 2010; Waldie 2010). Government accounts for 19.7 per cent of revenues, earnings from membership fees 15.9%, and contributions from households 12%.[35]

Within the charity sector income earning activity appears to be widespread. A recent study of charities earning $30,000 or more (Lasby 2013) found that between one half (58%) and three quarters (77%) of charities rely on earned income to some extent. About one third of the charities generating earned income described themselves as social enterprises, but nearly half said they were not (Lasby 2013).These activities provided an average 31% of the charities' total revenue. Much of this activity involved collecting membership fees (38% of charities), or charging user or program fees (30%) rather than generating revenue from running a business (Lasby 2013). Some 42% of these charities' activities made a profit, while 31% registered a net loss (Lasby 2013).

A recent survey of Ontario social enterprises found that almost half (46%) of all nonprofits surveyed were engaged in social enterprise (business) activity, and one-third (32%) of the remaining nonprofits were considering engaging in business activity within two years. For one in four non-profits with social enterprise activities, the business contributed more than 50% towards the parent non-profit's operating budget (Malhotra et al 2010). Over half of all nonprofit social enterprises surveyed indicated revenues between $250,000 and $5 million (Malhotra et al 2010).

2.3 Cooperatives

Prior to the recent B.C. and Nova Scotia legal initiatives, cooperatives were the only legal form specifically designed for social enterprises. The legal framework for cooperatives consists of largely provincial incorporation laws. Canada has over 9000 cooperatives, worth $370 billion in assets, with 18 million members.[36] Cooperatives are considered social enterprises in Canada because, though businesses, they are required in law to meet the needs of their members, rather than external shareholders, and they do not distribute profit based on share-ownership.[37]

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[34] Statistics Canada. Table 388-0001 - Production, income and outlay accounts of nonprofit institutions and volunteering, annual (dollars)
[35] Op Cit.
[36] See the Government of Canada's Cooperative Secretariat: http://www.tbs-sct.gc.ca/hidb-bdih/initiative-eng.aspx?Hi=81
[37] Canadian Cooperative Association www.coopscanada.coop/en/about_co-operative/How-are-Co-operatives-Different?

Cooperatives have a wide range of purposes, from purely commercial to charitable (Bridge 2010). They include, for example, credit unions, farmer cooperatives, food cooperatives and other retail cooperatives. Most primarily serve their members' interests, but some serve broader community purposes, and some serve both member and community interests (Bridge 2010)[38].

Cooperatives operate like regular for-profit companies in being able to make profits and distribute them, and they pay taxes on their net income (Bridge 2010; BCCSE 2013). However, cooperatives' distribution of profits is capped, and paid principally to members (rather than to outside investors) (Bridge 2010; BCCSE 2013). Remaining surpluses are required to be re-directed to these purposes (BCCSE 2013; Manwaring et al 2012). These legal restrictions ensure that the cooperative retains enough revenue to maintain or improve services, or promote the well-being of the community it serves (Bridge 2010).

Most cooperatives can also issue shares to outside investors to raise capital for projects, like regular for-profit companies (Bridge 2010), although non-members generally have no right to vote on resolutions (BCCSE 2013), and community purpose cooperatives cannot issue shares at all(Bridge 2010). Because of their limited return on investment and democratic governance, however, cooperatives are considered less attractive to external investors than other companies (BCCSE 2013). Some cooperatives also write an asset lock into their company articles to prevent the cooperative's assets from moving into private hands if the cooperative dissolves (Bridge 2010; BCCSE 2013).

The cooperative legal form already includes the two key features provided by the new B.C.C3s and Nova Scotia CICs discussed in Section 3: it builds the social enterprise's social purpose into its legal structure, while giving the social enterprise more freedom to operate like a regular for-profit business in terms of finances, governance and administrative burden (BC 2013). Why is this legal form not more central to Canadian social enterprise? One key difference between the cooperative form and alternative legal forms is its democratic structure and governance. Members control the cooperative's operations – one member one vote (Bridge 2010). Members' profit share is based on how much they use the cooperative's services (Bridge 2010). For many European commentators, democratic governance and structure is one of the defining features of social enterprise (e.g. DeFourny & Nyssens 2008). Canadian commentators suggest that the cooperative legal form may have limited appeal in Canada precisely because of this democratic structure (BCCSE 2013). The cooperative form is seen to rely for its success on the presence of a (large or small) mass of engaged and competent members who want to cooperate and collaborate together (Bridge 2010). It may therefore be attractive to social enterprises able to mobilize such a mass (Bridge 2010), but would have no appeal for individualistic social

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[38] One of the seven key principles for a cooperative, according to the International Co-operative Alliance states, is focus on the member needs (and also) working for the sustainable development of their communities through policies accepted by their members. The principle applies to all co-ops, both for –profit and non-profit (Bridge & Corriveau 2009).

entrepreneurs wanting to create and run their own enterprises, and whose social goals may not involve specific communities of people or place (Bridge 2010).

2.4 For-Profit Corporations

The most common legal form used by social enterprises wanting to make significant profits is the regular for-profit share corporation. The legal framework for for-profit corporations is largely governed by provincial corporation laws. An unknown number of Canadian social enterprises use this legal form. As for-profit corporations, social enterprises are free to pursue nearly any specific purpose, but for-profit corporations are not set up to include social purposes (Blumberg 2013). Their essential objective in law is to maximize shareholder value viz. profits, (BCCSE 2013; Bridge 2010). As major shareholders, a group of social entrepreneurs can vote to incorporate or prioritize social objectives in the corporation's articles of association (BCCSE 2013*)*. However, the enterprise's articles are reversible, and a change in the shareholder mix could lead to the social enterprise converting to a regular for-profit corporation. Historically, shareholders could sue management of a share corporation if the company did not maximize profits, but recent case law in Canada and the U.S. has settled that directors may consider the interests of a broader group of stakeholders than just the investors, even if this affects bottom line.

As for-profit corporations, for-profit social enterprises are not restricted in how much profit they distribute (depending on stipulations in their articles of association). They pay corporate income tax. They cannot receive donations, and they do not receive tax breaks to support their social ends, but they can donate up to 75% of their profits to charities and other eligible organizations (Randall 2013).

For-profit social enterprises can also raise equity capital as well as using debt and other financing instruments. However, given their primarily, or exclusively, social ends, most for-profit social enterprises are unlikely to make major profits, and will want to use most of their profits to grow the organization or otherwise advance their social ends. For-profit social enterprises do not appear to be very attractive to conventional investors, to judge by policy-makers' and the sector's concerns about access to financing (of all types, not just equity) (e.g. Malhotra et al 2010), and the sector's very low use of equity financing. A recent Ontario survey of social enterprises found that 41% of low profit for-profit social enterprises (also known as social purpose businesses) relied on lines of credit, 34% on personal savings, and 25% on non-bank loans (Malhotra et al 2010).

The administrative burden for for-profit social enterprises is relatively low. In addition, it permits social entrepreneurs to both control and run their social enterprises, and be paid well for it. Remuneration does not need to meet any standards of reasonableness as it is in non-profit and charitable organizations. Experts recommend the for-profit model for social enterprises that require investment to start up or scale up, and/or where an individual entrepreneur wants to both operate the business and be remunerated (Blumberg 2013 ; BCCSE 2013).

2.5 Partnerships

Social enterprises can also adopt the legal form of a partnership. The number of social enterprise partnerships is unknown. The legal form of partnership is largely governed by provincial laws. While partnerships can pursue a wide range of ends, they are required in law to "carry [..] on a business in common with a view to earning profits" (Markey et al 2011; Carter et al 2009; Manwaring et al 2012). Canadian non-profits and charities therefore cannot use the partnership form.

Partnerships offer more flexibility than for-profit corporations. The purposes they pursue, how the organization will be governed and operate, and how much and to whom the profits will be distributed is all determined by agreement among the partners, and spelled out in the partnership's operating agreement. It is therefore relatively easy to entrench the social enterprise's social ends into its operating agreement. However, as the partners change, so the agreement can also be changed.

Like for-profit corporations, partnerships are unrestricted in how much profit they distribute (depending on stipulations of their operating agreement). The partnership or partners pay income tax. And the administrative burden for partnerships is relatively low. As in for profit corporations, the partnership legal form permits social entrepreneurs to both control and run their social enterprises, and be paid well for it. Remuneration does not need to meet any standards of reasonableness as it is in non-profit and charitable organizations.

One major drawback for partnerships in Canada, however, is the lack of limited liability for partners. There does not exist in Canada the 'limited liability company' (LLC) legal form available in virtually all U.S. states and relatively widely used (Bromberger 2007; Kelley 2009). The LLC combines the flexibility of a partnership with limited liability for the partners (Bromberger 2007; Kelley 2009).

2.6 Conclusion

Canadian social enterprises are able to operate under a range of legal forms in Canada, but these forms do not fit well with the basic structure of social enterprise, even if they work well for some/many individual social enterprises. At its simplest, the legal forms that place no formal restriction on income generation make it more difficult to pursue social ends, while the legal forms designed for organizations with social ends provide only limited opportunities for earning business income and raising external financing. Not-for-profit social enterprises find ways around the limits on earning business income, at some cost and effort – for example, in the charity sector, by setting up the social enterprise as an arms-length for profit entity. For profit social enterprises need to take care to entrench their social goals in their operating articles. Only 14% of social enterprises surveyed recently in Ontario said that their current tax and regulatory framework allowed them to grow and thrive financially, and over one-third of all the nonprofits surveyed agreed that the existing legal framework is a deterrent to social enterprise activity (Malhotra et al 2010).

Overlaying the challenges specific to social enterprises from these legal forms is the inadequate state of the non-profit and charity regulatory framework as a whole – the framework is considered to be outdated, incomplete and inadequate (e.g. Bridge and Corriveau 2009; Chenier 2012, Mulholland et al 2011).

Some critics of the current regulatory framework call for an overhaul of the current regulatory structure, and a new approach to regulating social enterprises and not-for-profits (non-profits and charities) (e.g. Mulholland et al 2011; Aptowitzer 2009). They locate the origins of the current regulatory situation in: a lack of harmonized regulation across provinces and territories, which creates challenges that are not well managed; a lack of unifying national vision and goals for the not-for-profit sector that could guide the regulatory division of labour among governments as well as regulatory choices; and a lack of an intergovernmental mechanism to sort out problems (Mulholland et al 2011). As a result, the CRA has tended to expand its role to fill the vacuum. But its approach to the not-for-profit sector is seen to fail to balance Finance Canada's concerns about unfair competition from non-profits, with society's overarching interest in a viable, sustainable not-for-profit sector. There is debate about whether the CRA now exceeds its legitimate purview (Aptowitzer 2009), or whether its current role is a necessary evil right now (Mulholland et al 2011).

While there have been some changes in the regulatory frameworks in recent years (Bridge and Corriveau 2009) – for example, new Ontario and federal non-profit laws, a new Ontario charity law, creation of a new hybrid cooperative in British Columbia (BCCSE 2013), loosening of regulations around CED charities – the regulatory framework is considered not to have kept pace with the growth in social enterprise (e.g. Bridge & Corriveau 2009; Mulholland et al 2011; Malhotra et al 2010).

What do social enterprises need?

A primary challenge for social enterprises whatever their legal form is securing financial resources. Limited access to risk and social investment capital is seen as a primary obstacle to non-charitable social enterprise projects such as affordable housing, community economic development, or environmental initiatives (Canadian Task Force on Social Finance 2010; Bridge & Corriveau 21010; Bridge 2010; Weber& Geobey 2010; Mulholland et al 2011; Treurnicht 2011; McIsaac & Moody 2013; Rajotte 2009; Malhotra t al 2010; Flatt et al 2013). In particular, in Canada as elsewhere, social enterprises are seen to need social investment – investment from investors content to make low rates of return because they support the enterprise's social purposes, or patient investors content to wait for a reasonable rate of return (Canadian Task Force on Social Finance 2010; Bridge & Corriveau 2009).

Often the social enterprise can become self-sustaining, but lacks sufficient start-up funds. However, even funding for charitable ventures can be unpredictable or inadequate. More broadly, charities, and non-profits are facing declining government funding and income from philanthropy, while service demands escalate (Mulholland et al 2011).

> *"Charities and non-profits rely on three core sources of revenue: government funding, philanthropy, and earned income. Of these, only earned income offers any prospect for long-term growth.' (Mulholland et al 2011)*

A recent survey of Ontario social enterprises (including non-profits and charities, and low profit for-profits) found that 86% of non-profits with social enterprise activity were trying to increase their revenues from their business activities (Malhotra et al 2010). Some 79 per cent of social purpose businesses and 75 per cent of nonprofits with social enterprises, surveyed said access to capital was a prime issue for their social ventures (Malhotra et al 2010). Some 70 per cent of other nonprofits also cited access to capital as a major issue, and both social enterprise and other nonprofits expressed difficulty and dissatisfaction with current funding sources: donations and government funding, though most utilized, are the most difficult to access for more than half of all non-profits, and were dissatisfactory for a majority (>60%) (Malhotra et al 2010). While for-profit social enterprises ('social purpose businesses') use bank loans and lines of credit heavily, 67% of those surveyed were dissatisfied with the available sources of debt capital (Malhotra et al 2010).

In a more recent study of Ontario social enterprises (non-profits and for-profits), 80% of respondents considered access to external capital a challenge, nearly half of these reporting it a significant challenge (Flatt et al 2013).

This said, there is some evidence that more capital may exist for social enterprises than is being taken up, particularly for for-profits (e.g.McIsaac & Moody 2013; Elson[39]) Many respondents to the recent Ontario survey of social enterprises felt capital for social enterprise growth was widely available (Flatt et al 2013). Some respondents perceived the lack of loan-ready demand from social enterprises as a greater challenge than access to capital (Flatt et al 2013). Among non-profits in particular, debt financing appears underused, although lack of collateral may be one reason for this. The Ontario study found 84% of respondent social enterprises did not receive loans, whereas only 16% did not receive grants (Flatt et al 2013). A major challenge may then be to connect demand with supply (McIsaac & Moody 2013). Some commentators have suggested that non-profit management and financial literacy are a serious barrier to setting up social enterprises (Elson).[40]

[39] Elson. Op Cit.
[40] Ibid.

Proposals to Improve Existing Legal Forms

Experts and practitioners have proposed a range of reforms to improve the current regulatory regime for not-for-profits, including system-level changes such as limiting the CRA's role in administration of federal tax law, and establishing a joint federal-provincial process to modernize and harmonize provincial-territorial rules and regulations affecting the sector across Canada (Mulholland et al 2011).

Specific changes are also proposed to make the regulatory regime more supportive of non-profits and charities, and particularly to increase their access to financial resources – proposals for new incentives to increase charitable donations, for example (Aptowitzer & Dachis 2012), or, in the case of the recent Parliamentary Finance Committee Report, tweaking existing provisions, such as raising the contribution level for corporate donations (Aptowitzer 2013a). These changes would indirectly support social enterprises.

In addition, some proposals are specifically intended to support social enterprises, in particular to increase their access to financial resources. These include, for example, a tax break for investment in social enterprises along the lines of the Nova Scotia tax break for social enterprises and similar organizations with social purposes (Bridge 2010). Proponents argue that such as tax break would give social enterprises freedom to choose the legal form best suited for the enterprise, while still retaining a tax break (Bridge 2010). Eligibility for this tax break would be a community benefit test.

Other proposals call for loosening the restrictions on non-profits making profits. One possibility is to restore the destination rule on non-profit profits (i.e. allowing profits as long as they are used to advance the organization's non-profit purposes), which the CRA once allowed – although experts consider this highly unlikely to happen. Other experts suggest changing the tax law to put social enterprise non-profits in the same or similar tax categories as chambers of commerce and amateur athletic associations, which are permitted to make profits though they are non-profits or quasi-charities. Yet another suggestion is to revise tax law to give non-charitable social enterprises access to charitable tax benefits by deeming certain purposes or activities as akin to charitable purposes, as the CRA has done with certain CED activities (Broder 2010).

Some experts are not optimistic about possible regulatory changes for non-profit social enterprises, because of regulators' longstanding concern about unfair competition from non-profits or charities competing in the same markets as for-profit companies. Such a concern may be one of the factors underlying the policy turn towards support for low-profit for profit social enterprises.

A New Legal Form

Late in 2009, the Parliamentary Standing Committee on Finance presented a report to Parliament entitled *A Prosperous and Sustainable Future for Canada: Needed Federal Actions* (Rajotte 2009). Among its recommendations was "the creation of a corporate structure for not-for-profit organizations that would allow the issuance of share capital and other securities." The creation of such a legal entity had been proposed by several leaders in the social enterprise sector as a way to support the sector's growth and development. The following section looks at two such legal entities created in Canada since publication of the Committee's report.

Section 3: New Legal Forms for Canadian Social Enterprise

In 2012-13 British Columbia and Nova Scotia introduced similar new legal forms designed specifically for social enterprises. Both these new entities were modelled on the U.K.'s pioneering Community Interest Company. This section describes the main features of these new legal entities, what their creators intend them to achieve, and their reception from social enterprise experts.

The key innovative feature of both these new legal forms is that they build the social enterprise's social purpose into its legal structure, while giving the social enterprise more freedom to operate like a regular for-profit business in terms of finances, governance and administrative burden (BC 2013). These new legal forms are intended to complement rather than replace the legal forms currently used by social enterprises, and discussed in detail in the previous section (e.g. Bridge & Corriveau 2009).

3.1 British Columbia's Community Contribution Companies (C3s)

B.C.'s C3s came into being in 2012, and the regulations came into effect July 29, 2013. [41] To be designated a C3, an organization must first incorporate as a for-profit under the *Business Corporations Act of British Columbia* (the "BCBCA")[42], and then meet several additional requirements laid out in an amendment Act[43] (BC 2012-rid). These include:

(a) Community Purpose

C3s must have as one of their primary purposes a 'community purpose'.[44] This is defined in law as a purpose beneficial to the society at large or to a segment of society broader than friends, family or other persons related to the C3.[45] These community purposes must be non-charitable and thus broader than charitable purposes. [46] The law mentions 'providing health, social, environmental, cultural educational or other services' as examples of community purposes; it also includes political purposes as legitimate C3 purposes.[47] The government says that it has left the definition of 'community purpose' broad to 'encourage social innovation', but that it may narrow

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[41] B.C. Reg.63/2013. Business Corporations Act. Community Contribution Company Regulation http://www.bclaws.ca/EPLibraries/bclaws_new/document/ID/freeside/63_2013
[42] Ibid.
[43] *Bill 23: Finance Statutes Amendment Act.* (2012). 1st Reading, 39th Parliament, 4th session. Retrieved from the Legislative Assembly of British Columbia website: http://www.leg.bc.ca/39th4th/1st_read/gov23-1.htm.
[44] Ibid.
[45] Ibid.
[46] British Columbia Ministry of Finance (n.d.). *Questions and answers: Community contribution companies (C3s).* Vancouver, BC, CAN: British Columbia Ministry of Finance. Retrieved October 16, 2013, from, http://www.fin.gov.bc.ca/prs/ccc/caq.htm.
[47] Bill 23. Op Cit.

the definition by regulation if it finds C3s adopting 'inappropriate purposes'.[48] These community purposes must be set out in the company's articles of association.[49]

C3s must actually have in their name either the words "Community Contribution Company" or the abbreviation "CCC.[50]" The intent is seen to give anyone investing in or interacting with a CCC clear notice that it has not only a community purpose but that there are restrictions on how it can disburse its assets (Tang 2013). The law also prohibits a CCC from amalgamating into other jurisdictions, where presumably there is no guarantee that the Asset Lock provisions or the notice requirements will be maintained (Tang 2013).

(b) Asset Lock

C3s' ability to make profit is unrestricted, but both the distribution of profits and the dispersal of assets are capped to ensure that most of these profits are used to advance the social enterprise's social purposes.

Dividend Cap

C3s may issue dividends to shareholders, but the C3 regulations limit the total amount of annual distributable profits to 40% of total profit, plus any unpaid dividends up to 40% carried over from a previous financial year.[51] C3s are thus free to limit profit distribution in their early years, and reward investors' patience once they are established. The 40% cap is a little more generous than the current U.K. cap of 35% (see Section 4). The B.C. government says it has chosen a less restrictive approach to "increase investment by allowing for greater incentives".[52]

There is no cap on profit distribution for C3s owned by registered charities and qualified donees. [53] This means that CICs set up as trading arms or social enterprises by charities or other qualified donees can give their parent organization up to 75% of their profits, like regular for-profit corporations. C3s can have one or many shareholders (BCCSE 2013), and may issue multiple classes and series of shares (Blatchford 2013). C3s that solicit investor funding are subject to securities regulation.[54]

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48 BC Ministry of Finance, Op. Cit.
49 Bill 23. Op. Cit.
50 Bill 23. Op. Cit.
51 B.C. Reg.63/2013. Op Cit.
52 B.C. Min Finance. OpCit.
53 B.C. Reg.63/2013. Op Cit.
54 B.C.Min Finance.Op.Cit.

Asset Transfers

While operating, C3s can transfer their assets without restriction to charities, community service co-operatives, and any other of the other 'qualified donees' [55] defined by federal tax law.[56] (BC 2013; Blatchford 2013). This includes First Nations and aboriginal groups.[57] But transfers of assets to any non-qualified done must be at fair market value.[58]

On voluntary dissolution, C3s must transfer at least 60% of their assets to other C3s, charities or other 'qualified donees' under federal tax law, or the new community service co-operatives as defined in B.C.'s Cooperative Association Act.[59] The remaining 40% may be distributed to C3 shareholders. On involuntary dissolution, any assets would be automatically turned over to the government, and returned to the C3 if it were restored to the corporate register (as a C3) (Mason 2013). These restrictions on corporate reorganizations are designed to ensure that payout restrictions cannot be circumvented (BC 2012).

(c) Annual Community Contribution Report

The main accountability measure for C3s is an annual Community Contribution Report that must contain 'a fair and accurate description of the manner in which the company's activities during that financial year benefited society'.[60] This report will include, among other things: relevant information on the financial position of the company; the total amount of assets; including money that was transferred in furtherance of the company's community purposes, including transfers to charities and other qualified donees; the total amount of dividends declared on all classes of shares; the identity of shareholders receiving dividends; a list of the most highly remunerated persons (remuneration exceeding $75,000) (Mason 2013). [61] The Community Contribution Report must be kept at the C3's corporate records office and posted on the C3's website if it has one (Burns 2013).

(d) *Regulatory Oversight*

C3s' activities are not overseen by a dedicated regulatory body like their counterparts in the U.K. and Nova Scotia. The B.C. government says their primary accountability mechanisms will be the annual Community Contribution Report, monitoring by the company's shareholders and customers, and its requirement that C3s have at least three directors (BC 2013).[62] In rejecting a

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[55] See Section 2 for a list of qualified donees.
[56] B.C. Reg.63/2013. Op Cit.
[57] B.C.Min Finance. Op Cit.
[58] Bill 23. Op Cit. Also B.C. Reg.63/2013. Op.Cit.
[59] B.C. Reg.63/2013. Op. Cit.
[60] B.C. Reg.63/2013. Op. Cit.
[61] B.C. Reg 63/2013. Op. Cit.
[62] B.C. Min. Finance. Op. Cit.

dedicated regulatory body for C3s, the B.C. government says that a U.K.-style regulator is 'inconsistent with the current role of the Corporate Registry and with the nature of an automated incorporation and filing system'.[63]

C3s receive no special tax benefits,[64] and pay taxes like any other for-profit corporation.[65] The B.C. government says this situation will not change unless federal tax laws are revised.[66] However, there is some speculation among commentators that the B.C. government may introduce a special tax credit for C3 investors (e.g. Burns 2013; Mason 2013).

Charities and non-profits are ineligible for C3 registration, and charities may not convert to C3s (Blumberg 2013). Charities may create C3s as arms-length subsidiaries, in lieu of the for-profit corporation form they now typically use; indeed, one of the B.C. government's aims in creating the C3 was to encourage charities to house their arms-length profit-making subsidiaries in a C3(Burns 2013; BC 2013).

As discussed in Section 2, recent CRA missives suggest that non-profits may also be able to set up C3 subsidiaries, depending on the specifics of the case (Valentine 2013; Robertson 2013; Drache 2012). In a 2013 letter explicitly addressing the issue of non-profits setting up C3s, the CRA stated that non-profits do not necessarily lose their tax exempt status when they engage in income-generating activity carried out by a wholly-owned taxable corporation, and receive dividends from that corporation (Robertson 2013). In 2012, the CRA had issued two technical interpretations stating the view that non-profits that used excess funds to purchase and make loans to a taxable subsidiary would be viewed as having a profit motive, since the non-profit clearly had more money than it needed to do its non-profit work (Man 2013).

3.2 Nova Scotia's Community Interest Companies (CICs)

Nova Scotia's *Community Interest Companies Act*[67] received Royal Assent on December 6, 2012, but regulations spelling out specific details such as the dividend cap have yet to be announced. Nova Scotia's Community Interest Companies (CICs) resemble the B.C. and U.K. entities in most respects:

- Organizations incorporate under the *Companies Act*,[68] and must then meet additional legal requirements to be designated as CICs (Lazier 2012).

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[63] B.C. Min. Finance. Op.Cit.
[64] For example, they cannot receive funding from foundations because they are not qualified donees.
[65] Bill 23. Op. Cit.
[66] B.C. Min.Finance. Op.Cit
[67] *Bill 153: An Act Respecting Community Interest Companies*. (2012). 1st Reading November 28, 2012, 61st General Assembly, 4th Session. Government of Nova Scotia. Available at: http://nslegislature.ca/legc/bills/61st_4th/1st_read/b153.htm.
[68] *Companies Act (1989)*. Available at: http://nslegislature.ca/legc/statutes/companies.pdf

- They require an explicit community purpose, which is broader than charitable purposes – given examples of which are “without limiting the generality of the foregoing, a purpose of providing health, social, environmental, cultural, educational or other services.”[69] Commentators suggest that the government’s construal of "purposes beneficial to society" will be broader than the CRA’s construal of charitable objects, in part at least because CICs are not tax exempt, and cannot issue tax receipts, while charities can (Randall 2013a).
- The community purpose is to be written into their corporate articles.[70]
- Assets are locked: the distribution of profits is capped (to a level not yet announced), and the distribution of assets while the CIC is in operation, and once it dissolves, is severely restricted. At dissolution, CICs’ assets can only be transferred to another qualified entity, which includes cooperative organizations under the *Cooperative Associations Act*, registered charities, or non-profits under the province’s *Societies Act*.[71]
- CICs submit annual Community Interest Reports that provide a ‘fair and accurate description’ of how the enterprise has “benefitted society or advanced (its) community purpose.”[72]
- CICs are taxed as regular for-profit corporations.

A prominent difference between Nova Scotia’s CICs and B.C.’s C3s is in their regulatory oversight: unlike B.C., Nova Scotia has followed the U.K. in establishing a Registrar to oversee CICs. Nova Scotia’s Registrar of Joint Stock Companies decides whether a company is to be designated a CIC designation, and can de-designate any company it decides has failed its purposes, or demand any information needed to confirm that the company is still pursuing its community purpose.[73] The Registrar also must receive a copy of a CIC’s Community Interest Report.

Other differences between CICs and the B.C. C3s include CIC provisions that assets can be distributed to non-profits as well as qualified donees, and the ineligibility for CIC status of organizations with political purposes. In addition, CIC annual Community Interest Reports do not need to list the incomes of the organization’s most highly paid employees.[74]

In addition to the legislation, the Nova Scotia government has also introduced a Social Enterprise Loan Guarantee for local credit union loans to ‘not for profit, non-profit, cooperatives and social purpose businesses which are for profit but designed to fulfill a social mission’ (ERDT 2012; NSCC n.d.). The guarantee covers up to 90% of loans up to $150,000. The loan guarantee program introduced in mid-2012 was presented as the first step of the Province’s social enterprise

[69] Bill 153. Op.Cit.
[70] Bill 153. Op.Cit.
[71] Bill 153. Op.Cit.
[72] Bill 153. Op.Cit.
[73] Bill 153. Op.Cit.
[74] Bill 153. Op.Cit

strategy. As noted earlier, Nova Scotia already provides a 35% tax credit to investors in nonprofits, and may well extend this to CICs.

3.3 The New Legal Entities: Intentions and Predictions

Attitudes towards C3s and CICs among experts and the social enterprise community have tended to be very positive (e.g. Bull Housser 2013; Bridge 2010; Mason 2013; BCSIC 2012; Kwan 2013; Chenier 2012;) and both experts and the social enterprise community were active in the development of the new legal forms (e.g. B.C. Social Innovation Council). In personal interviews conducted with several social enterprise experts, the majority tended to see the creation of these new legal forms as quite positive, and that these new legal forms fill a need among social enterprise. Some social enterprise experts have expressed reservations about their ability to attract investment, including social investment, given their dividend cap. Others have adopted a wait-and-see attitude, commenting that the success of the new forms would be demonstrated in the extent of social enterprise take-up of the new option. They suggested that it may take some time for these new legal forms to become known and familiar within the social enterprise sector. A few questioned the need for a new legal form, arguing that focus on the creation of new legal forms is a distraction from other social enterprise policy reform (e.g. Jamieson et al 2011).

3.3.1 The Purpose for CICs/C3s

As indicated earlier, the new legal forms are intended to add to social enterprises' choice of legal forms, rather than to supplant their use of the legal forms they already use (e.g. Bridge & Corriveau 2009). What, then, is their specific purpose? The B.C. government positions C3s as a vehicle to harness 'socially focused' investment currently not accessible to the social enterprise sector', to 'help foster social enterprise investments', with the ultimate goal of increasing wealth creation and employment (BC 2012).

> *"This new model will unlock new ways to generate meaningful, local employment in B.C. and generate economic wealth for our province by encouraging private investment in B.C.'s social enterprise sector…."* Minister of Finance Michael de Jong (BC 2012).

To this end, the B.C. government anticipates C3s will be able to raise equity investment from socially conscious investors who may be unwilling to invest in companies that lack a legally required social purpose. They would be attracted by the C3's 'legal obligation to conduct business for social purposes and not purely for private gain', assured through its asset-lock and legal community purpose, and its consequent distinctive 'brand'.[75]

[75] B.C. Min. Finance .Op.Cit.

Experts commenting on the C3 have also suggested that the new legal model will enable social enterprise to access equity financing from socially-conscious investors, and to borrow against capital assets at potentially more favourable rates (e.g. Bull Housser 2013; Burns 2013; BCCSE 2013; Mason 2013; Burns 2013a). Given their limited ability to reward investors, they are thought to be unattractive to conventional equity markets (e.g. Burns 2013).

In addition, some anticipate that the C3 will become the 'vehicle of choice' for charities or non-profit organizations wishing to carry on arms-length businesses (Mason 2013; Burns 2013; BCCSE 2013; Bull Housser 2013; Burns 2013a). Some have noted that, as qualified donees, local governments will be able to use the C3 model to house a wider range of projects than they currently can with charities (Mason 2013). Local governments can already partner with CED charities in community local development projects within CED charity parameters, and with other charities (see Section 2).

Many commentators say that their social purpose 'brand' will also make C3s/CICs attractive to for-profit social enterprises, both stand alone and subsidiaries, since their form clearly differentiates them from regular for-profits in the market (e.g. Mason 2013; Bridge 2010; Blatchford 2014).

3.3.1 Potential Users

As already intimated, the new legal forms are expected to be attractive to social enterprises that want to be able to raise equity capital from social investors that do not expect conventional rates of return on investment. These may include social enterprises that are currently, or considering becoming, incorporated as regular for-profits, or those currently, or considering becoming, incorporated as non-profits. As a C3/CIC, they may also benefit from lower loan rates than currently available to non-profits and charities. As already indicated, existing charities may not register as one of the new legal forms. Social enterprises eligible to register as charities would need to weigh the financial benefits of charitable status against the potential benefits of acquiring equity capital, in determining the financial benefits of becoming a C3 or CIC. However, several commentators have pointed out that the C3s and CICs are not intended to affect the charity sector in this way.

Social entrepreneurs may also be more likely to prefer a C3/CIC form than regular non-profit incorporation (or charity status) if it is important for them to both direct the enterprise and earn income from it at the same time. As discussed in Section 2, directors of non-profits and charities cannot be remunerated for their work. In addition, experts have suggested that regular for-profit social enterprises may be attracted to C3s/CICs for their brand – they convey the enterprise's social goals in a way that a regular for-profit may not.

As already indicated, charities are expected to find C3s/CICs attractive legal forms in which to house arms-length subsidiaries, compared to the current typical for-profit legal form.

Non-profits with a structure that passes CRA scrutiny may also be able to create C3 arms-length subsidiaries, as discussed above (Valentine 2013; Robertson 2013; Drache 2012; Tang 2013a). While the C3/CICS offer no additional tax advantages to the parent charity or non-profit, they offer a clear social purpose 'brand' for their subsidiaries.

3.3.2 Issues

As alluded to above, one concern about the C3s and CICs voiced by some experts is whether their dividend cap and other asset locks may deter investors from investing in these enterprises (e.g. Mason 2013; Bull Housser 2013 a; Bridge & Corriveau 2009; Bouw 2013). For example, investors will not be able to retrieve their investment from a C3 that dissolves involuntarily, and may not be able to retrieve it from a voluntary dissolution (since 60% of assets must go to a qualified done organization).

Initial responses from lenders and lawyers who work with social enterprises were varied:

> *"The devil is in the details. New models require testing and refinement, along with extra support of early adopters, or they are simply a public relations exercise … time will tell if it's a symbolic gesture or if there is real commitment to social goods" (Joel Solomon, chair of Vancouver-based social venture financing firm Renewal Funds.)* (Quoted in Bouw 2013).

> *"We see C3 as another tool that will help increase the number of companies out there that will be thoughtfully run. Our credit won't have to turn them down because they are structured for a double bottom line, but don't have a legal structure that will protect that. This is just one more thing that should allow us to move more capital into community goals. It's more of the kind of business we're looking for." (Andy Broderick, vice president of community investment at Vancity, which helped draft the legislation).* (Quoted in Bouw 2013).

> *"If a charity came in to see me, I would encourage them to use the C3 model. Whereas if a small business owner or young entrepreneur came in I would discourage them because I feel they don't need the extra regulation" (Del Friday, lawyer with Kuhn LLP, Vancouver).* (Quoted in Kwan 2013).

Another concern for some experts is the lack of direct regulatory oversight for C3s (e.g. Lazier 2012). Extensive abuse of the CCC 'brand' -- by companies that do not in fact pursue the social purposes they are legal bound to pursue – would eventually undermine the value of these new legal forms.

A third concern is the potential lack of interest among social enterprises in the new legal form, given their current low use of other available financing such as commercial loans. They agree that time will answer this concern. While reporting requirements for CICs are relatively low, some commentators worry that they may still be too high for under-resourced social enterprises (Mason 2013; Bouw 2013).

Finally, the question has been raised whether CICs may draw financial resources away from charities. Some current donors to charities may prefer to invest their money into a CIC and receive financial as well as social returns, even though their donations to charity are tax deductible (Blatchford 2014).

Section 4: The U.K. Community Interest Company and its Context

The U.K. has been a leader among Anglo-American countries in promoting social enterprises. The sector has been strongly supported by government through a range of policy papers and initiatives since the late 1990s (e.g. DTI 2006; DTI 2002; SU 2002; OTS 2006), and is seen to have a highly developed institutional support structure (McKay et al 2011; Nicholls 2010). Social enterprise seems to be growing rapidly as a result (BMG 2013; SEUK 2011). The government claims at least 70,000 social enterprises in the U.K. (BMG 2013), compared to an estimated 5,000 or so in 2003 (Teasdale, Lyon & Baldock 2013). However, the huge increase may reflect the government's broadening definition of social enterprise as much as any real growth.[viii] It has been estimated there would be have been 8,500-16,360 SEs in the U.K. by 2009 using the older definitions (Teasdale, Lyon & Baldock 2013).

The U.K. government has articulated various purposes for social enterprises over the last 15 years. Initially, it promoted them as vehicles to regenerate the U.K.'s most deprived communities (HM Treasury 1999; DTI 2002). By the mid-2000s, it proposed them to deal with 'some of society's most entrenched problems,' with social, cultural and environmental problems not being addressed by either not-for-profit or for-profit sectors, or with the failure of the third sector to scale up(OTS 2006; OTS 2009; Chew 2010; DTI 2002; Teasdale 2010). Increasingly over the last decade, government has promoted them as vehicles to deliver publicly-funded services (through competitive contract) or as receptables for health, education and social services 'spun-off' from the public sector (e.g. HM Treasury 1999; OTS 2006; OTS 2009). For example, charities that earn income through successful competitive contracting to deliver government services are called social enterprises (e.g. SEUK 2011).

On the ground, U.K. social enterprises still tend to be concentrated in deprived, largely urban, U.K. communities where, among other things, they most often deliver health and social services, often on contract to the government (SEUK 2011). Also common in these communities are social enterprises that provide temporary or permanent employment, as well as training (SEUK 2011; Aiken 2007). In 2011, about one third of all social enterprise start-ups were in these communities, and 39% of these were in the most deprived communities (SEUK 2011).

In 2005, the U.K. introduced its legally innovative Community Interest Company (CIC), designed specifically to support U.K. social enterprises. This section describes the U.K. legal innovation on which Canada's recent legal innovations are modeled. It also looks at what creators expected it to achieve. Before discussing the CIC, it describes the legal and social context for social enterprises surrounding introduction of the CIC.

4.1 The Legal Forms that U.K. Social Enterprises use

As in Canada, U.K. social enterprises are a diverse group of organizations, ranging from charities and their profit-making subsidiaries, to social firms[76], labour market integration enterprises, development trusts, co-operatives and credit unions, community businesses[77], and regular for-profits with some social purpose (Chew 2010; Chew & Lyon 2012; BMG 2013).

Similar to the Canadian experience, U.K. social enterprises that incorporate use several legal forms, most of which, prior to 2005, were not designed for social enterprises. One important difference between the U.K. and Canadian legal landscape for social enterprise stands out: the U.K. absence of a non-profit, or non-share corporation. This means that most of the legal forms used by U.K. social enterprises do not legally secure the enterprise's social purposes; they do not prohibit the distribution of assets, income or profits, which is to say, they do not 'lock' their assets and income. Only charities' social purposes are completely locked (Lloyd 2010; NCVO 2012). As in Canada, charity status in the U.K. prohibits the distribution of charities' assets and income into private hands.

The absence of a clear legal dichotomy between for-profit and non-profit in the U.K. leaves a large 'middle space' between for-profits and charities filled by not-for-profits and low-profit for profits. These 740,000 organizations, and the U.K.'s 160,000 or so charities, form the Third Sector,[78] which includes, for example, cooperatives, financial mutual societies, building societies, employee-owned businesses, housing associations,[79] as well as other not-for-profit organizations which in Canada would incorporate as non-profits.

Most not-for-profit organizations, and charities, in the Third Sector are unincorporated – an estimated 86% of charities, for example (Morris 2012). More social enterprises in the Third sector would be incorporated to make it easier to run their business. Here is a description of the legal forms that social enterprises most often use.

[76] U.K. 'social businesses' employ primarily people with disabilities (Aiken 2007). They are similar to social businesses in Canada, which are included among the CRA's community economic development 'charitable activities' (Aiken 2007).
[77] U.K. community businesses are organizations that trade in commercial markets, sometimes competing with the private sector for public sector contracts for activities such as delivering second-hand furniture. Many of them employ highly disadvantaged individuals, and have as the/a social purpose the integration of these individuals into the labour market (Aiken 2007).
[78] Now more often called Civil Society, or the Big Society.
[79] For the full range of organizations included in Civil Society, see the National Council of Voluntary Organizations : http://data.ncvo.org.uk/a/almanac14/what-is-civil-society-2/

4.1.1 Companies Limited by Guarantee

Most not-for-profits incorporate as companies limited by guarantee (CLGs). These include, for example, charities, development trusts, community enterprises and some cooperatives requiring corporate status (LawWorks 2012; SU 2002).[80] CLGs are limited liability companies that operate like regular for-profits in being able to make profits and distribute them, and paying CLG directors. Like other corporations, they are also taxable.

The key difference between CLGs and regular share corporations is that CLGs are owned by, and distribute their profits to, members rather than to external investors. CLGs can therefore raise loan capital, but not share capital.[81] Charities and other not-for-profits typically secure their CLG's social purposes by writing these purposes into the company's articles. The company articles of charitable and not-for-profit CLGs will prohibit assets and income from being distributed into private hands during operation, and at dissolution[82] (LawWorks 2012). They also usually prohibit payment of CLG directors. [83] The drawback for social enterprises incorporating as CLGs is that the company's members can change the company articles at any time, so their social purposes are not permanently locked in. In addition, CLGs are seen as having a 'taint' of for-profit purposes, even when their company articles say otherwise (SU 2002). Despite their wide use, CLGs seem less of a suitable fit for social enterprises and other organizations than the North American non-profit corporation.

Some 67% of companies limited by guarantee self-defined as social enterprises in recent government surveys of the small and medium business (SMEs) sector and the Third Sector organizations, which defined social enterprises as earning at least 25% of their income from sales of goods and services, and retained at least 50% of their income from business activity (NCVO 2012).[84]

4.1.2 Industrial and Provident Society (IPS)

A smaller number of social enterprises and other not-for-profits incorporate as Industrial and Provident Societies (IPS). IPSs are limited liability organizations controlled and run by member-shareholders democratically (DTI 2003). They include the familiar cooperative, as well as the U.K.- specific community benefit companies ('bencoms'), which by law must serve the

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[80] See also Company Law Club. *Community Interest Companies*. Retrieved September 15, 2013 from: http://www.communitycompanies.co.uk/guaranteecompanies.shtml
[81] Ibid.
[82] Ibid.
[83] Ibid.
[84] Data available at: http://data.ncvo-vol.org.uk/a/almanac12/almanac/civil-society/what-is-the-relationship-between-social-enterprise-and-civil-society/.

broader community.[85] Bencoms range from building societies to working men's clubs, allotment societies, Women's Institute markets, housing associations, football supporters' groups, social groups and local interest, literary or historical societies.[86] Not-for-profit IPS social enterprises are typically bencoms.

Like Canadian cooperatives, IPSs raise capital through membership,[87] and cooperatives make and distribute their profits to their members. However, bencoms are nearly completely asset-locked: they cannot distribute assets or profits to their members, and they can only pay members interest on their capital (DTI 2003a; Law Works 2012). In addition, when bencoms dissolve, their assets must pass to some other body with similar objects, and not to the members (LawWorks 2102).[88] IPSs' profits are taxable (LawWorks 2012).[89] Bencoms and cooperatives can also write a full asset lock on their assets and income into their company articles. Bencoms can be also charities if their purposes are charitable (LawWorks 2012; SU2002).

Cooperatives and bencoms are far less common now than in the 1980s, when the Thatcher government privatized most of them (put them into private hands). Since bencoms provide nearly as secure a lock on their assets and income as charities, they would seem potentially attractive to social enterprises that pursue broader-than-charitable social purposes and want these purposes legally secured. Yet they are not widely used by social enterprises (or other not-for-profit organizations). The law governing IPSs dates from the 1960s, and is seen to be sorely outdated. In addition, IPSs are distinctive in their democratic operations and ownership. In the U.K. as in Canada, IPS are thought to require a solidaristic membership base, and therefore to be unattractive to individualistic social entrepreneurs wanting to control and run the social enterprise.

Some 72% of IPSs defined themselves as social enterprises in the recent government surveys of the small and medium business (SMEs) sector and the Third Sector organizations described above (NCVO 2012).[90]

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[85] HM Revenue & Customs. *CTM40505 - Particular bodies: industrial and provident societies: background.* Retrieved September 15, 2013 from http://www.hmrc.gov.uk/manuals/ctmanual/CTM40505.htm.
[86] Company Law Club. *Industrial Provident Societies.* Retrieved September 15, 2013 from, http://www.communitycompanies.co.uk/industrialandprovidentsocieties.shtml
[87] Share capital is capped at a low (£20,000) per member to maximize access to membership. Members receive only one vote each, regardless of their investment, and the interest paid on share capital is capped (at fixed margin above a standard interest rate, like that of the Bank of England)(DTI 2003).
[88] HM Revenue & Customs. Op.Cit.
[89] Company Law Club. Op.Cit.
[90] Data available at: http://data.ncvo-vol.org.uk/a/almanac12/almanac/civil-society/what-is-the-relationship-between-social-enterprise-and-civil-society/.

4.1.3 Organizations with Charitable Status

As in Canada, charities are prominent among U.K. social enterprises. Some 45% of U.K. charities are estimated to be social enterprises, based on the criterion of earning 25% or more of their income from trading (NCVO 2012).[91] Until very recently, the U.K.'s 163,000 charities[92] had no distinctive charitable legal form. In the absence of a non-profit legal entity, charities usually incorporated as CLGs or, less often, IPSs (SU 2002; Teasdale et al 2013) [93]. Charitable CLGs and bencoms have company articles that lock the organization's assets and income during operation and at dissolution (Law Works 2012; Teasdale et al 2013).

In 2012, the government created the charity-specific Charitable Incorporated Organization (CIO) to increase charity incorporation[94] (LawWorks 2011, 2012). But, as yet, charities are not required to become CIOs, and 'charity' continues to be a status rather than a legal form, regulated by the Charities Commission (and now, also, a *Charities Act* (2006))[95]. The U.K. criteria for charitable status are similar to the Canadian criteria.[ix]

The government recommends that social enterprises with charitable social purposes register as charities, largely for the tax benefits (BIS2010a). However, the government recognizes that some social enterprises will not want the high administrative burden of being charity, and many social entrepreneurs will want to both direct their enterprise, and be paid, which is prohibited in charities (LawWorks 2012; CC2007).

Charities and Trading

U.K. charities can operate businesses but, as in Canada, only within strict limits (CC 2007).[96] U.K. charity rules regulate charity 'trading', a broader category than 'operating a business'. Trading covers most but not all the commercial and business activities that the CRA permits. For example, 'trading' includes charging fees for services – even where this is done to defray costs and with no intent to profit (CC 2007). But it does not include selling donated goods (CC 2007).

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[91] Ibid.
[92] In the U.K., the term 'charities' usually refer to 'general charities', a large subset of all registered charities that excludes registered charities controlled by government, independent schools, religious organisations and some others. (See National Council for Voluntary Organizations: http://data.ncvo.org.uk/a/almanac14/what-is-the-voluntary-sector/. All data for 'charities' in this report is for general charities. General charities are also often called 'voluntary sector organizations'.

[94] CIOs combine the advantages of a limited liability corporate structure (such as reduced risk of personal liability for trustees), with no burden of dual regulation by company and charity law; CIOs will only register with and report to the Charity Commission (LawWorks2012). CIO directors are called 'charity trustees' rather than 'directors' to reflect charities' distinctive traditions (LawWorks2012a).
[95] This law is seen as largely consolidating earlier case law, legislation and regulations.
[96] Company Law Club. *Charitable Trading Companies.*Op Cit.

“Trading” is defined as the buying and selling of goods and services (CC 2007), and so includes any income earned from government contracts to deliver services as well as income earned from market activity.

As in Canada, U.K. charity trading rules distinguish between trading conducted as part of the charity’s core purposes and activities (primary purpose trading), and trading not directly related to their core activities (non-primary purpose trading). [x] Primary purpose trading can make profits, which are tax exempt as long as the charity uses them for its charitable purposes (the destination rule)(LawWorks 2012; CC 2007). Social businesses, and employment training businesses are also allowed as charitable activities (as in Canada, under the CRA’s Community Economic Development activities provisions (CC 2007).

Arms-Length Trading Subsidiaries

U.K. charities that trade in areas not directly related to their core purposes have to house them in arms-length subsidiaries unless they pose minimal financial risk to the charity(CC 2007). Most charity trading subsidiaries’ goal is to make profits for the parent charity (LawWorks 2011; CC 2007). Charities often house their primary purpose trading activities in such subsidiaries too. As in Canada, these trading arms have to be completely separate entities from the parent charity (LawWorks 2011; CC2007).

U.K. trading subsidiaries can be CLGs or regular share corporations (LawWorks 2011) or, occasionally, IPSs(NCVO 2012), with the charity as sole shareholder or member. Most are set up as share companies (LawWorks 2011).[97] As in Canada, the parent charity must retain control over the subsidiary’s organization and operations.[98] One reason for choosing a regular share company over a company limited by guarantee for a trading arm is to give confidence to suppliers, customers, and creditors, or where the trading subsidiary would risk insolvency if capitalized by loan (LawWorks 2011).

Charity trading arms are taxable, but they can gift 100% of their profits to their parent charity tax-free (LawWorks 2011; BIS 2010; CC2007), and the tax system encourages this (CC 2007). The U.K.’s Gift Aid allows companies to gift charities money on which the company has already paid tax, but the charity can claim the pre-tax value of the gift on its own tax, thus adding about 20% value to the original gift.[99] As a result, trading arms are potentially more lucrative, and attractive, for U.K. than for Canadian charities. As in Canada, U.K. trading arms can also raise financing in ways not available to the parent charity.[xi]

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97 Company Law Club *Charitable Trading Companies*. Op.Cit.
98 Ibid.
99 HM Revenue & Customs. *Giving to Charity through Gift Aid.* Retrieved March 28, 2014 from, http://www.hmrc.gov.uk/individuals/giving/gift-aid.htm.

Although more charities are said to be setting up trading arms -- in part to secure government contracts (Chew 2010; Chew&Lyon 2012; McKay et al 2011) – the proportion of charities with trading arms is still quite small. Only 1,800 general charities reported income from trading subsidiaries in 2009/201, worth about 1.5% of all charity income (NCVO 2012).[100] But as a group they operated at a loss (NCVO 12).[101]

4.1.4 Trusts

Trusts are popular in the Third Sector though, like charities, they are not a separate legal form, but are fairly popular in the Third Sector. Trusts usually incorporate as CLGs, and may also be charities. This is the case for many of the Development Trusts that have driven regeneration in impoverished U.K. communities. However, since trusts also aim to earn income through trading activities, and they are limited in how they can trade, they often set up subsidiary trading companies that gift profits back to the main charitable company.[102]

4.1.5 Companies Limited by shares (CLSs)

Prior to the introduction of CICs, most for-profit U.K. social enterprises incorporated as U.K. companies limited by shares, which offer same operating freedoms as Canadian for-profit corporations. As in Canada, social enterprises cannot legally secure their social purposes in the for-profit corporate model, since companies limited by share are expected in law to maximize profits and to distribute them to their private owners. In the recent government surveys noted above, an estimated 26% of private small and medium companies limited by shares identified as social enterprises (NCVO 2012).[103]

4.1.6 Limited Liability Partnerships (LLPs)

The Limited Liability Partnership (LLP) is found in the U.S. as well as the U.K., but not in Canada(BIS 2011). A for-profit option for social enterprises, it combines the flexibility of a partnership with limited liability for the partners. The U.K. government recommends LLPs for joint ventures or mutual models of ownership and control because of its flexible core purposes, operating structure, and profit distribution. All of these are spelled out in the partners' operating

[100] The actual figure is thought to be higher because of accounting variations (NCVO 2012).
[101] For more detail, see: //data.ncvo-vol.org.uk/a/almanac12/almanac/voluntary-sector/income-in-focus/how-much-do-organisations-generate-from-their-trading-subsidiaries/.
[102] More information on trusts is available at: http://www.partnerships.org.uk/pguide/trusts.htm
[103] Data available at: http://data.ncvo-vol.org.uk/a/almanac12/almanac/civil-society/what-is-the-relationship-between-social-enterprise-and-civil-society/. These would be companies that self-defined as social enterprises, and which earned 25% or more of their income from trading, and distributed no more than 50% of their profits to investors annually. However, it has been pointed out that many companies retain most of their profits in any one year for internal reasons not connected with serving social purposes (Teasdale, Lyon & Baldock 2013).

agreement. Social enterprise LLPs can therefore have primarily social purposes(BIS 2011), but as with other U.K. legal forms, these can be retracted at any time by the partners (BIS 2011).

4.1.7 Conclusion

Like Canadian social enterprises, U.K. social enterprises can use a variety of legal forms, very few of which were designed for social enterprise, prior to introduction of Community Interest Companies (CICs). However, the absence of the non-profit legal form in the U.K. leaves a major legal lacuna for social enterprises that pursue broader social goals than charities (or reject its administrative burden or governance restrictions), and want their social goals legally secured. Prior to introduction of the CIC, only charities and, perhaps IPSs, provided social enterprises with a secure asset lock. Moreover, the slightly more flexible bencoms are increasingly rare.[104] As a result, most not-for-profit social enterprises use the 'profit tainted' CLG legal form (SU 2002) to incorporate, and write their social purposes into the company's articles. But these purposes are reversible. And the CLG's profit 'taint' tarnishes their brand appeal (SU 2002).

For for-profit U.K. social enterprises, the challenges of securing their social goals, and of raising equity capital in an equity market wanting maximum returns, appear to be the same as for their counterparts in Canada.

4.2 Other Drivers for Regulatory Change

Beyond the limitations of the existing legal framework, other environmental factors have also helped drive the push for new legal options for social enterprises.

The first has been financial. Declining government grant revenues, the general economic uncertainty – exacerbated by the economic crash of 2008 – and increasing competition for voluntary donations and government grants has been forcing U.K. charities and other Third Sector organizations to turn increasingly to trade to generate income (Eikenberry & Kluver 2004; Eikenberry 2009; Teasdale 2010; Chew & Lyon 2012; Chew 2010; Chew 2005).[105]

Trading is now the single largest source of income for U.K. charities, earning £21.4 billion in 2010/11, up 92% from 2000/2001 (NVCO 2013). For the Third Sector as a whole, social enterprise/ trading accounted for 71% of the sector's total revenue in 2009 (NCVO 2012).

Government policies have also helped drive the turn to trade (Chew 2010; Chew & Lyon 2012; Spear 2004; Alcock et al.2004; SU 2002). It has been a priority of successive governments over the

[104] Company Law Club. *Industrial Provident Societies.*Op.Cit.
[105] See also: https//www.socialenterprise.org.uk/about/about-social-enterprise#legal. Retrieved September 25, 2013.

last 15 years to outsource delivery of many public services, and to 'spin-out' entire public services to social enterprises and to mutual associations (SEC 2011; Chew 2010; DTI 2002). Most of the shed services are health and social services. The current government accelerated this trend recently with its decision to 'spin-out' of many National Health Service services to newly minted mutual associations of former NHS employees, or to social enterprises. In 2010, it predicted its formerly public National Health Service would become the 'largest social enterprise sector in the world' (SEUK 2011). The government is promoting mutual and social enterprises as vehicles for these services in preference to direct privatization (e.g. OTS 2009; OTS 2006).

Much of the considerable policy activity around the charity and broader not-for-profit sector in recent years is thought to be aimed at increasing Third Sector capacity to deliver public services on contract (e.g. Morris 2012). The creation of the Charitable Incorporated Organization (CIO) is considered an example of this (Morris 2012) since it makes it administratively easier for Third sector organizations to contract.[106] The government also recently passed new procurement legislation, the *Public Services (Social Value) Act*[107] intended to incorporate social value considerations into public procurement criteria. [108] (The original bill aimed to give Third Sector organizations preference in contracting, but the final law is felt to merely 'nudge' commissioners into considering social value (Teasdale, Buckingham & Rees 2013). Other initiatives are designed to enhance charities' financial resources, such as a new Charity Commission guidance which dilutes the 'public benefit test' to enable charities to charge higher fees. [109]

The government's new social enterprise legal form can be seen as part of this broader strategy to set up the Third Sector as receptacles for public services. Although not part of its original creator's intention, it may account for at least some of the government's strong support and promotion of the CIC.

The commingling of the not-for-profit sector's need for earned revenue, and the government's desire to shed public service delivery has led U.K. charities to rely increasingly on government service delivery contracts for their income (Haugh & Kitson 2007; Carmel & Horlock 2008; Teasdale, Kerlin, et al. 2013). Such contracts accounted for about half of U.K. charities trading income in 2010/2011(NCVO 2013). About 30% of charities received income from government in

[106] For example, by protecting charity trustees against personal liability under trading contracts.
[107] For more information, see https://www.gov.uk/government/news/significant-boost-to-social-enterprises-as-the-social-value-act-comes-into-force. (31 January 2013), retrieved December 5, 2013.
[108] Social enterprises working mainly with the public sector also cite government procurement policy as the second greatest barrier to their sustainability – a greater barrier than cash flow (SEUK 2011).
[109] See: http://www.thirdsector.co.uk/news/1211877/charity-commission-publishes-new-public-benefit-guidance. The debate over the permitted increase in charities' fees for service is over whether the charging of fees puts charities in violation of the public benefit test, since fees potentially make the charity's service unaffordable to lower income individuals, and thus exclude them from benefit. The new guidance tells charities that measures to ensure access for the poor must be more than minimal or token. But it is up to the charity, not the courts, to decide how to do this.

one form or another in 2010/2011, and 20% relied on government for more than half their income (NVCO 2013). Given the small number of charities reporting income from trading subsidiaries in 2009/2010, most government service delivery contracts are likely run as projects within the charity.

The most recent survey of the social enterprise sector also found, however, that social enterprises have begun trying to reduce their reliance on government contracts, and want to diversify their revenue sources more (SEUK 2011). Many report government contract income to be precarious and unsustainable (Mulkerrin & Gaughan 2013).

4.2.1 What Social Enterprises Need

As the previous discussion shows, one of the primary challenges for social enterprises in the U.K. as in Canada, whether not-for-profit or for-profit, is access to financial resources. The most recent survey of the sector by Social Enterprise U.K. in 2011 found that 44% of respondents reported that lack of availability and affordability of finance hampered their sustainability (SEUK 2011).

Government consultation and policy reports also repeatedly identify lack of access to financing as one of the main barriers to growth for social enterprises (e.g. DTI 2002; SU 2002; HM Treasury 2013; DTI 2003). In addition to regulatory barriers, the government identifies lack of both supply and demand as part of the problem with financing. On the supply side, the U.K. has been seen to lack a developed social investment market for social enterprises (BIS 2010a; DTI 2003).

On the demand side, U.K. social enterprises have shown limited appetite for equity financing, including both conventional and angel financing (DTI 2003; BIS 2010a). A 2003 Bank of England study found some demand among social enterprises for patient finance, particularly at the start-up and expansion stages (BIS 2010a). More recent research has found more interest in equity investment among Third Sector social enterprises, due perhaps to their increasing reliance on contract-based income, debt financing, and other more independent income generation (BIS 2010a). However, social enterprises still rarely use equity financing (BIS 2010a). Social enterprises thus have a financing profile similar to that of other small businesses, except that social enterprises appear to need less collateral than other small businesses to get loans (BIS 2010a).

Research cited by the government also suggests that a lack of financing products and channels to bring social financing to market social enterprises also contributes to the financial challenges facing social enterprises, since these organizations can be expected to rely more on social finance markets than on conventional markets(BIS 2010a). By one estimate, only £3.3 million equity and £5.5 million quasi-equity was raised for the total investment market in 2010/2011 (Mulkerrin & Gaughan 2013).

4.3 The Community Interest Company

4.3.1 What is a CIC?

The U.K. government introduced the Community Interest Company specifically to promote social enterprise and to remove some of the barriers to its growth (SU 2002; Ashton 2006; Eaglesham 2005). The idea of a social enterprise-specific legal form was first floated in 2002 (SU 2002), and the CIC became law in 2005. In proposing the CIC, the government dismissed the idea that the CIC was to replace other existing legal forms for social enterprises, saying it was to be a complement to existing legal options (DTI 2003a).

As noted in Section 3, the U.K. CIC is the model for B.C's Community Contribution Company (C3/CCC) and Nova Scotia's Community Interest Company. As in Canada, U.K. social enterprises first need to incorporate companies under company law,[110] and then meet additional legal requirements to be CICs. These are laid out in specific CIC legislation and regulations[111]. One important difference with the Canadian legal forms is that U.K. CICs can be companies limited by share, or companies limited by guarantee (BIS 2010). Moreover, companies limited by share can be regular for profit CICs, or they can be Schedule 2 CICs, which can only pay dividends to other asset-locked bodies.[112] Schedule 2 CIC companies by share would thus likely be charity trading arms. Charities and IPSs cannot be CICs (BIS 2009), though conversions are allowed (BIS 2010; LawWorks 2011).

There had been initial debate on whether CICs should be able to issue equity shares. However, the government decided that ' if CICs are to have the scope to grow, they will need access to a range of sources of finance" (DTI 2003a).

The additional legal requirements for U.K. CICs include:

(a) Community Interest Test

CICs must carry on activities that a reasonable person would consider to genuinely benefit the community, whether directly or that 'in some sense contribute to' achieving purposes that

[110] The U.K. *Companies Act (2006)*. Available at: http://www.legislation.gov.uk/ukpga/2006/46/pdfs/ukpga_20060046_en.pdf
[111] The *Companies (Audit, Investigations and Community Enterprise) Act 2004*, available at http://www.legislation.gov.uk/ukpga/2004/27/pdfs/ukpga_20040027_en.pdf. Also the *Community Interest Company Regulations 2005,* available at http://www.legislation.gov.uk/uksi/2005/1788/regulation/23/made
[112] However, CICs cannot covert from a company limited by guarantee to a company limited by share, and vice-versa (BIS 2011)

benefit the community (BIS 2010).[113] This range of purposes is deliberately broad – examples given are: working with the disadvantaged, training the unemployed, improving the local environment, or rebuilding the economy and improving productivity, competitiveness and innovation (Haugh & Paredo 2011).[114] In applying to be a CIC, social enterprises must submit a community interest statement to the CIC regulator (see below) describing the company`s social purpose, including whether it plans to distribute profits or not (BIS 2010; LawWorks 2011).

Asset Lock

Like Canadian C3s and CICs, U.K. CICs ability to make profits is unrestricted, but the distribution of profits and assets is restricted to ensure that most of the financial resources are used to advance social purposes. The caps were intended to be set at a point which 'strikes a balance between maximizing access to finance and maintaining the credibility of the asset lock" (DTI 2003).

<u>Dividend Cap</u>

CICs limited by shares may issue dividends to investors, but this distribution is capped (DTI 2004). The caps on dividends have been raised twice since 2005, first in 2010, and most recently in 2013.

The initial cap was a double cap on annual distribution of total profit, and on annual per share dividends. The cap on dividends per share was set at 5% above the Bank of England base lending rate, while the cap on distribution of total profit as set at 35% of the CIC's distributable profits (BIS 2010). A cap was also imposed on interest payable on performance-related loans from banks and other lenders (a little-used form of quasi-equity, in which the interest paid on a loan is based on the organization's performance) (BIS 2010). The loan cap was set at 4% above the Bank of England base rate (Lloyd 2010; BIS 2010). To prevent investors from gaining indirect control of the CIC and using it to increase their returns at the expense of the CIC's social mission, CIC law requires that decisions to declare a dividend must be made by all members of the company, not just directors (Lloyd 2010).

A cap on dividends per share meant that the value of their share does not rise (BIS 2010); in effect CIC investors are paid income on their investments via their dividends (Lloyd 2010).

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[113] Any group of individuals may constitute a community, other than private groups such as family, club members (BIS 2010).

[114] To date there have not been many court cases interpreting "the community benefit". CIC's creator has wondered publicly how community benefit might be defined where trade-offs are involved: Would running a chemical factory that was highly polluting but produced useful drugs be in the interest of the community? (Lloyd 2010).

However, despite widespread understanding to the contrary, it appears that CIC shares can be sold for more than their paid-up value (BIS 2013).

In April 2010, following consultations with social enterprises and lenders, the government raised the per share dividend cap to 20% of the paid up value of the share (Lloyd 2010; BIS 2010), amid criticism that the rate was too low to attract investors (BIS 2010a). The cap on distribution of total profit was kept at 35%, but unused capacity was allowed to be carried over for up to five years (BIS 2010; BIS 2010a; Lloyd 2010). [115] The cap on interest payable on performance related loans was raised to 10% above the Bank of England base rate (Lloyd 2010; BIS 2010).

At the end of 2013, following another round of consultations with social enterprises and lenders in 2012, the government announced it was revising the caps again (BIS 2013). The cap on dividends per share was removed altogether, while the cap on distribution of total profit was kept at 35% (BIS 2013). The cap on interest from performance related loans was raised again to 20% (BIS 2103). Initially, the government had been concerned that a simple cap on distribution of total profit ("to say, 20%, 25%, or 33%') would open up more scope for risk capital, making very high returns to investors possible, and weakening the profit lock to a greater extent than per share caps (DTI 2003a).

Asset Transfers

While operating, CICs can transfer their assets only to another asset-locked body such as a charity, an IPS, or a foreign equivalent of an asset-locked body specified in their articles of association, or for the benefit of the community (with CIC Regulator consent); or at full market value only to entities that are not asset locked (BIS2010). However, CICs can provide services to other CICs, charities, and other asset-locked bodies at below-market rates (BIS 2010). At dissolution, CIC assets can only be transferred to other asset-locked bodies, or at full market value to other entities (BIS 2010).

(b) Community Interest Reports

CICs must submit annual community interest reports to the CIC regulator describing their activities, and how these activities advanced their social purposes outlined in their community interest statements (BIS 2010). These are available to the public. The purpose of these reports was to ensure transparency for the communities the CICs served (they are independently monitored by the CIC Regulator Office (see below)).

[115] A distribution of 35% of profits in any one year is thought to be quite a high cap, given than most U.K. banks do not distribute more than about 25% of their profits (Lloyd 2010).

d) Regulatory Oversight

CICs are regulated by a special Office of the CIC Regulator – initially completely independent but now folded into the Department of Trade & Industry – which is authorized to approve (and rescind) CIC designations, monitor compliance, review annual reports from CICs, and report annually to Parliament on its activities (BIS 2010).

Like their Canadian counterparts, U.K. CICs pay taxes like other corporation and until very recently received virtually no special tax benefits. Their only CIC-specific tax advantages has been specific region-based tax relief, and access to Lottery and other funding not available to regular for-profit companies.[116] Like other corporations, they may also gift up to 100% of their pre-tax profits to a charity (LawWorks 2011; BIS 2010: CC2007), including a parent charity of which they are a subsidiary. As of 2014, CICs will also have access to a tax credit for investors in charities and social enterprises, announced in the government's 2013 budget (see more below).

CICs also receive indirect government tax support through the Community Interest Tax Relief [CITR], which provides a tax break of 5% of investment per year of a five-year investment, to investors a Community Development Finance Institution that lends to or invests in a qualifying community profit distributing enterprise or community project (DTI 2003a).

Despite having a dedicated CIC Regulator, the regulation of CICs is considered 'light touch' by the government, carrying a lower regulatory burden than charity regulation. Like other companies by guarantee or companies by share, CICs are allowed to pay their directors, making them attractive to social entrepreneurs who want to run their enterprise and be paid for their work. (This would not be true for CIC companies by guarantee that prohibit payment of directors in their articles of incorporation.) However, the level of director remuneration must be 'reasonable' and in the best interests of the CIC and the community as overseen by the Regulator (CIC 2006).

4.3.2 How Innovative is the CIC?

The key innovative feature of the CIC in the U.K. legal context as in the Canadian context is that it protects social enterprises' social purpose by building it into its legal structure, while at the same time giving social enterprises more freedom to operate like a regular for-profit business in terms of finances, governance and administrative burden (Lloyd 2010). In law, the idea of a dividend cap is quite new (DTI 2003a).

However, CICs as originally conceived do share many features with community benefit companies ('bencoms'), one of the two types of IPSs which already had their own IPS-specific

[116] Company Law Club. *Community Interest Companies.* Op.Cit.

legal form. As indicated earlier, bencoms are prohibited by law from distributing profits and assets to members, but pay members capped interest payments on capital (DTI 2003a). During the government's early consultations on its proposed new CIC, several respondents argued that the government should modernize the outdated IPS legal form rather than create a new legal form (DTI 2003). The government rejected this proposal, on the grounds that bencoms' democratic governance would deny 'flexibility' to those wanting to tailor their governance in other ways (DTI 2003), and 'would not always be appropriate for the wide range of activities envisaged for CICs' (DTI 2003a). In addition, "the BenCom approach of limiting returns to interest payments, with no profit distribution admissible, would be even more restrictive for CICs" (DTI 2003a). Respondents argued that introduction of the CIC would eclipse IPSs given the cost and burden of IPS regulation (DTI 2003).

4.3.3 The CIC: Intentions and Predictions

When it first introduced the idea of the CIC, the government argued that a CIC would create a 'strong new not-for-profit brand' for small scale community-based social entrepreneurs (SU 2002). Subsequent government statements have repeated this view, presenting CICs as a device to allow social enterprises with broad social objectives to "clearly signal their social or environmental credentials" (OTS 2006; BIS 2010).

These government documents indicate that the value of this 'brand' will be to increase public understanding and trust in social enterprise, and also increase social enterprise's access to finance (SU 2002; OTS 2006; BIS 2010). These values are related, insofar as the CIC brand is intended to increase the financial sector's understanding and trust as well as that of the buying public. The importance of the CIC in increasing access to finance for social enterprise has been a consistent government theme. At the launch event for the CIC legal form, then enterprise minister Alun Michael stressed its potential for increasing investment: 'we want the marketplace for social investment to grow as people see social enterprises growing and delivering at local, regional and national levels' (Eaglesham, 2005). In the same vein,

'The CIC will present new opportunities for social enterprises to benefit the people they serve: Easy for investors to understand, with an assured lock on profits and assets to attract social investors, it will help create a strong new brand for social enterprise and a new marketplace for social investment" (Patricia Hewitt, Secretary of State for Health, on publication of a joint DTI/Home Office/Treasury consultation document on March 26th 2003).[117]

Attracting investment was also flagged as a major objective for CICs in the CIC Regulator's first annual report on CICs in 2006(CIC 2006).

[117] Statement reported at: http://www.cicassociation.org.uk/)

This said, there appears to have been no government expectation that all CICs would seek equity financing, or even external loans. Some CICs were expected to depend on grants or donations to support their activities (BIS 2010; DTI 2003). The government has supported this by setting up a new lottery distributor that would fund the community and social enterprise sector, including CICs (DTI 2003). Similarly, recent CIC Regulator's reports showcase CICs that have been successful in securing grants, as well as CICs that have successfully accessed external financing (e.g. CIC 2012, 2013, 2013a, 2014, 2014a,2014b).

Still, the government did expect that many CICs would seek external financing in the form of loans or equity (DTI 2003a), later if not initially. Recognizing when it introduced the CIC that the social investment market was still in the early stages of development, the government indicated at that time that demand for CIC shares might initially be limited (DTI 2003), and attractive only to philanthropic investors rather than to venture capitalists (DTI 2003). The government expected that CIC financing would primarily be in the form of philanthropic investment such as low-interest loans (DTI 2003a), or commercial bank loans (DTI 2003a). In some cases, it has recommended loan financing over equity investment for greater tax efficiency (BIS 2010). Only recently have government documents begun to include venture capital as a source of financing for CICs (Lloyd 2010).

The early government statements on CICs make clear that CICs were expected not only to benefit from social investment markets, but also to help develop those markets, by providing an appropriate investment vehicle (DTI 2003a). The government identified the lack of a developed social investment market as a problem to be solved (e.g. DTI 2003), and the CIC as one way to help solve it, in other words.

4.3.4 The CIC: Potential Users

The government has positioned CICs as an ideal legal form for community-based social entrepreneurs pursuing social purposes broader than charitable purposes. For these social entrepreneurs, the CIC offers a clear social purpose 'brand' to distinguish their enterprise from regular for-profit companies limited by share, and from the 'profit-tainted' companies limited by guarantee, more flexibility than alternative not-for-profit legal forms in operating and raising money, and the freedom to run the enterprise and be paid for it (BIS 2010).   Government examples of potential CIC social purposes include operating day care centres for the elderly, or providing commercial support services or recreational facilities (BIS 2010).

As mentioned earlier, CICs are not intended to displace charities (or the other existing legal forms). Given their tax benefits, the government describes charitable status as 'exactly right' for organizations with charitable objectives (BIS 2010) (CICs may have charitable purposes even if they cannot also register as charities (Chew 2010)). However, the government does suggest that new enterprises with charity-eligible purposes might consider becoming CICs instead, if they want to pursue trading, or if they hold real property, want to avoid charities' administrative burden, and are willing to forfeit charities tax benefits (BIS 2010).

CICs are also positioned as attractive vehicles for charity trading arms, by government (BIS 2010) and by commentators (Chew 2010).[118] One example given of such a trading arm is a charity shop (BIS 2010). While CICs have the same tax regime as alternative legal forms, only CICs combine legally secured social purposes with relative financing and operational freedom. Early government consultations on the CIC legal form found substantial appetite among charities for a CIC-type trading subsidiary (DTI 2003).

Finally, some commentators suggest the CIC legal form may appeal to unincorporated bodies with significant assets, that run recreational, village and community facilities. The CIC's limited liability provisions protect those running these unincorporated associations.[119]

4.4 Conclusion

Like Canadian social enterprises, U.K. social enterprises use a variety of legal forms, very few of which were designed for social purposes and their hybrid structure combining social purpose with business activity. However, the absence of a Canadian-type non-profit legal form in the U.K. has left a major legal lacuna for social enterprises that pursue broader social goals than charities (or reject its administrative burden or governance restrictions), and want their social goals legally secured. Prior to introduction of the CIC, only the assets and income of charities have been securely locked against distribution to individuals for person benefit. Bencoms, are also nearly asset locked, with minimal profit distribution in the form of capped interest payments on capita, but bencoms are increasingly rare.

The U.K. CIC, like the new Canadian CICs and C3s, for which it was a model, builds the social enterprise's social purpose into its legal structure, while giving the social enterprise more freedom than charities or bencoms to operate like a regular for-profit business in terms of financing strategies, a 'light touch' administrative burden, and the ability of individual social entrepreneurs to run the enterprise and be paid for it. Together these features give social enterprises a distinctive 'brand' to offer to the public, and to lenders and investors, particularly the social investment sector. The government hoped that its primary adopters would be community-based social enterprises with wider purposes than charities, as well as charities setting up trading arms to generate new sources of income.

A primary government goal for the new CICs was to open up new forms of financing for social enterprise, especially equity investment. It hoped this would be a two-way street, with CIC's

[118] Company Law Club. *Community Interest Companies*. Op.Cit
[119] Company Law Club. *Community Interest Companies*. Op.Cit.

acting as catalyst to develop the social investment sector. Also on the government's agenda, but not part of the CIC's original conception, was the ambition to create a new suitable legal receptacle for the outsourcing and 'spinning out' of public services that fell short of outright privatization.

Section 5: The Success of U.K. CICs

It is now nine years since the CICs were introduced in the U.K. This is time enough to make some initial assessment of its success, although its full impact on the U.K.'s social enterprise sector, and on its charity and wider Third Sector, may yet to be seen. This section looks at CIC take-up, types of social purposes that CICs pursue, their organizational and financial stability, and their sources of funding and financing to assess the CIC's impact on the social enterprise sector, and less directly, the U.K.'s Third Sector.

5.1 CIC Take-Up

The CIC legal form is widely considered to be a success, in terms of the numbers of registrations (UNDP 2008; CIC 2012, 2013). Whereas other legal forms introduced in Italy, Belgium and France, for example, have been underused (UNDP 2008), the number of CICs has grown consistently since 2005 to reach 8784 by December 2013 (CIC 2014b). The government appears pleased with the level of interest in the new legal form, although a recurrent theme in the CIC Regulator 's annual reports is that the CIC model still needs to become more widely known and understood, by investors, social entrepreneurs, and by Third Sector organizations seeking to trade (CIC 2011,2012,2013; HMT 2013).

CICs also appear to have become a significant presence in the U.K.'s social enterprise sector. If the government's (broadly defined)[120] estimate of 70,000 social enterprises in the U.K. is correct (BMG2013), then one in ten social enterprises appears to be a CIC. CICs may account for about 5% of U.K. small and medium businesses (SMEs) that declare themselves social enterprises, in addition to meeting that broad definition[121] (BMG 2013). Interestingly, only 90% of CICs considered themselves social enterprises in a similar survey of small and medium business the year before[122] (NCVO 2012).

[120] Defined as organizations earning 25% of more of their income from trade, and distributing no more than 50% of their profits to investors in any one year (BMG 2013)
[121] SMEs 'considering themselves social enterprises' refers to SMEs that self-reported as a very good fit with the survey's criteria for a social enterprise (BMG 2013). [121] The criteria: considering itself a social enterprise; paying no more than 50% of profit or surplus to owners or shareholders; generating not less than 25% if its income from trading; generating not more than 75% if its income from grants and donations; and agreeing that it is a business with primarily social/environmental objectives, whose surpluses are principally reinvested for that purpose in the business and community, rather than shareholders and owners (BMG 2013).
[122] Data available at: data.ncvo.org.uk/a/almanac12/what-is-the-relationship-between-social-enterprise-and-civil-society/

Growth in CICs has come largely from first time incorporations. Less than one eighth of registered CICs are organizations converting from another legal form (CIC 2014a; CIC 2011). (Against this, a total 47 CICs have converted to charities (CIC 2014b). Some registered CICs will not be operational – a snapshot in 2009 found an estimated 17% of CICs to be non-operational (Nicholls 2010). The social enterprise sector as a whole has also been growing rapidly during the period since CICs were introduced (SEUK 2011), suggesting that CIC growth is part of a larger trend, and not happening primarily at the expense of incorporations in other legal forms.

In terms of their size, CICs range from the very small to the very big. A snapshot of a random sample of CICs in 2009 found that 28% of CICs had less than £500 net assets, and only 13% had assets over £20,000 (Nicholls 2010). Some 29% earned less than £1000 per year, and 26% earned more than £50,000. On the other hand, the annual turnover of the largest CIC exceeded £51 million (Nicholls 2010). The larger CICs will include health or social services hived off from the U.K. public service, which may include as many as 4000 employees (Guardian 2012).

5.2 CICs: Types of Companies

By far the majority of companies registering as CICs have been companies limited by guarantee (78%) (CIC 2014b; BIS 2013). This percentage has remained fairly consistent since CICs were introduced in 2005, and in fact has risen slightly in recent years (CIC 2009). The high number of CIC companies limited by guarantee suggests that many CICs may be not-for-profit organizations in the Third Sector, combining CIC status with traditional company-by-guarantee incorporation. (Although companies limited by guarantee can make profits and distribute them to members, unless they write non-distribution provisions into their company articles.)

A further 12% of CICs are Schedule 2 companies limited by share, which can only pay dividends to other asset-locked bodies (BIS 2013). Most of these CICs are likely to be trading subsidiaries of charities or other Third Sector organizations. The proportion of CIC companies by share that are Schedule 2 companies also seems to have risen over time (BIS 2013; CIC 2009).

That leaves only 12% of CICs that are regular companies limited by share, and eligible to raise equity financing (BIS 2013).[123] This is a much smaller proportion of CICs than the government appears to have hoped for (BIS 2013), despite its own early predictions of a limited initial demand for CIC shares (and hence limited attraction of CIC companies limited by share) (DTI 2003). Recent government statements describe the small proportion of CIC companies-by-share as a problem that points to 'issues with the model' (BIS 2013), which seems 'unattractive in its current form' (BIS 2013).

[123] Most of the conversions into CICs from other legal forms have been to CIC companies limited by share (357 of the 631 conversion by March 31, 2011) (CIC 2011).

5.3 CICs: Areas of Activities

Most CICs are in education and health services (Mulkerrin &Gaughan 2013; CIC 2013), the 'heartland' of Third Sector organizations and of social enterprises (Peattie & Morley 2008). Health services includes social care, social housing, counselling, physical well being therapies and Primary Care Trusts or physician practices (CIC 2013). CICs also tend to be concentrated in the inner parts of large cities, where other social enterprises tend to be concentrated (Mulkerrin & Gaughan 2013).

Within these areas of activity, however, many CICs are reported to be 'breaking new ground and directly competing in traditional private sector activity' (Mulkerrin & Gaughan 2013), rather than just delivering conventional services on contract. For example, some of these CICs will be helping highly disadvantaged workers integrate into the labour market by giving them temporary or permanent work in child care or personal services businesses, delivered on contract with government (Davister et al 2004).[124]

CICs' concentration in education and health services may have intensified over the last few years as government has outsourced and spun-out more services to not-for-profits and mutual associations (employee-owned enterprises). In 2009/2010, the latest year for which the government provided details, 42% of CICs were in the field of physical well-being, radio & TV, arts, culture and literary businesses; 19% were in education; 15% were in health and social work, and 13% were in real estate (CIC 2010). CICs have proven a popular legal form for radio and TV social enterprises (CIC 2013).

Certainly, government outsourcing and 'spinning-out' has contributed to the growth of CICs, and to their concentration in health and education. By 2012, CICs had come to be seen as the favoured legal form for central and local government outsourcing (Mulkerrin &Gaughan 2013). The government itself has also created many health and education CICs as part of its 'spin-out' – 51 CICs created by its Health Lottery, for example, which distribute funds to local health service organizations (CIC 2012), as well as multiple health service CICs set up by its Quality Care Commission (CIC 2013). Spun-out CICs can be large – a planned Gloucestershire spin-out from the NHS, for example, involved more than 3,000 staff, nine local hospitals, district nursing, occupational therapy, and specialist domiciliary care (Guardian 2012).

5.4 Survival Rates

CIC dissolution rates have been high, though not necessarily higher than rates for other small and medium U.K. businesses. Dissolution rates have averaged 20% a year since 2005(CIC 2013), so that by September 30, 2013, 2,800 of the 11277 CICs created since 2005 had dissolved (CIC 2014a). The recurrent discussion of dissolutions in CIC Regulator annual reports suggests that

[124] These types of social enterprises are known in Europe as Work Integration Social Enterprises (WISEs).

dissolutions are seen as a problem (CIC 2012,2013), although the most recent annual report cited research that suggested CIC rates were comparable to rates for small and medium businesses (CIC 2013).

Most dissolving CICs appear not to be operational (CIC 2013; CIC 2012); about 20% of the CICs dissolving in 2012/2013 had never traded, and about 75% had traded for less than three years. A quarter of the CICs dissolving in 2012/2013 cited lack of funding as a reason for their dissolution (CIC 2013).

5.5 Reliance on Government

CICs rely heavily on government to fund their businesses. In 2008, 57% of CICs were receiving some form of revenue from government, as either grants or trade, and 31% saw the public sector as their most important income source (Clifford et al 2010). Much of this funding likely comes in the form of service delivery contracts. But government grants (or service delivery contracts) may also be the only financial recourse for CICs pursuing social purposes that are unlikely to become self-sustaining – for example, some businesses to alleviate poverty. Social enterprises working in the U.K.'s most deprived communities are the most heavily government funded (SEUK 2011).

CICs rely nearly as heavily on government funding as charities[125], and they rely more heavily than the U.K. social enterprise sector as a whole[126], which itself has been dubbed 'a creature of public funding and an alternative to in-house public services' (Peattie & Morley 2008). About half of all U.K. social enterprises trade with the government (compared to 30% of small businesses) and 18% of social enterprises rely principally on trade with government (SEUK 2011).[127]

Overall, CICs' current profile supports the widely held view that much of the growth and direction in CICs to date can be attributed to the government's own policies to outsource and spinout government services. CICs were not originally conceived for this purpose (Mulkerrin & Gaughan 2013; Lloyd 2010).

Their current profile also suggests that many CICs may not be all that different from other not-for-profit and charity organizations in their social purposes and in how they fund them. What attracts these types of CICs to the CIC model, then? Potentially improved access to funding

[125] In 2008, 61% of charities received some revenue from government, and 34% regarded government as their most important income source (Clifford et al 2010).
[126] A 2011 survey found that half of all U.K. social enterprises were trading with the public sector (compared to 30% of small business) in 2011, and government was the principal trading partner for 18% of social enterprises (SEUK 2011).
[127] However trade with the general public is the most important source of social enterprise income, with two thirds of social enterprises surveyed in 2011 saying they earn income from such trade, and 37% reporting it as their principal source of income (SEUK 2011). Smaller enterprises were less likely than larger enterprises (>£100k per year revenue) to trade with government for their income (SEUK 2011).

may be part of the answer (see below). But the CIC's asset-lock and 'brand' value, its administrative advantages for contracting, or its relaxed governance rules for social entrepreneurs may also figure in their choices.

5.6 Sources of Financing

As discussed earlier, CICs were created in part to give social enterprises access to new sources of financing, and to be a catalyst in development of some of those resources – to help create 'a new marketplace for social investment' (Hewitt, CICassociation.org u.k; DTI 2003a.). At the same time, some CICs were expected to rely on traditional funding from government and foundations.

The most recent survey evidence suggests that most CICs (57%) do not use equity or loan financing at start-up, even the conventional debt financing that companies limited by guarantee are eligible to use. Most rely on grants or self-funding (Mulkerrin & Gaughan 2013). Grants remain the 'lifeline of start-up finance' (Mulkerrin & Gaughan 2013); or many CIC entrepreneurs "absorb/ subsidize the risks themselves, taking on personal loans, using credit cards, redundancy payments" (Mulkerrin & Gaughan 2013). Of the 43% of CICs surveyed that did seek start up financing, about a third (15% of all respondents) said they sought equity financing (Mulkerrin &Gaughan 2013). The top 3 reasons given for seeking financing: need for working capital; business expansion; or purchase/renovation of land or buildings (Mulkerrin &Gaughan 2013).

CICs' relatively low use of external financing appears to mirror that of the U.K social enterprise sector as a whole. A 2011 social enterprise sector survey found that 47% of social enterprises had sought financing in the previous year (not necessarily start-up financing), while 61% had sought development grants (SEUK 2011).[128] Some 25% had sought loans, and four percent had sought equity financing (SEUK 2011).[129]

CICs' relatively low use of external financing is not fully explained by lenders' lack of interest. Most of the CICs that sought start-up financing got it (37% of all respondents) (Mulkerrin & Gaughan 2013). Similarly, just over half (56%) of the social enterprises that reported seeking loans in the previous year were successful, and 75% of the tiny numbers seeking equity investment were successful (SEUK 2011). Social enterprises seeking development grants were only slightly more successful (61%) than those who sought loans (SEUK 2011). One third of social

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[128] CICs accounted for about 10% of the survey sample. It is not known what percentage of organizations seeking equity financing were CICs.

[129] Larger social enterprises (>£250,000 annual income) more likely that smaller ones (<£10,000) to seek financing: 52% compared to 33% (SEUK 2011). Start-ups were three times as likely to approach a specialist social enterprise lender as a high street bank (SEUK 2011). The median amount of financing sought was £100,000, and the median amount achieved was £60,000 (SEUK 2011).

enterprises in a 2008 sector survey had reported seeking finance, and 71% of them said they had received 75-100% of what they asked for (CIC2010a).

5.7 CICs and Access to Financing/Funding

Both government and CICs see access to financing or funding as a major obstacle to CICs' growth. CICs report access to financing as their biggest single obstacle to success (Mulkerrin & Gaughan 2013). The CIC Regulator has consistently identified access difficulties for CICs seeking either traditional grant funding, or external loan and equity financing (e.g. CIC 2012; CIC 2013a). Her statements suggest that many non-share capital CICs did not become CICs to better access commercial loans but to make it easier to get government or foundation funding. Whether seeking traditional funding, loans or equity, CICs seem to be having difficulty getting the funding or finance they need, though not necessarily more difficulty than other social enterprises or small businesses (SEUK 2011; Mulkerrin & Gaughan 2013; BIS 2013). The Regulator's recurrent response (e.g. CIC 2013a) to CICs has been:

> *"The success stories are there, many are securing significant funding, investment and grant-aid. Being a CIC does not guarantee funding and we feel, at times, that it is less to do with the company model and more to do with having a strong business plan, a clear strategy and good corporate governance" (CIC 2012).*

The Regulator's statements acknowledge that CIC status on its own has not been enough to open more funders' doors. They also suggest that many CICs may lack the financial literacy and readiness required by funders. The survey of CICs also found that lack of investment readiness, lack of security and lack of financial skills hindered CIC access to finance (Mulkerrin & Gaughan 2013). Other government documents have also suggested that difficulties within social enterprises, as well as underdevelopment of intermediary mechanisms to connect social enterprises with investors in particular, are hindering CIC access to finance (HM Treasury 2013).

5.7.7 Equity Financing

As already noted, relatively few CICs are regular companies limited by share, and very few seek equity financing. Yet CIC companies by share cited attracting external investors as one of their top three reasons for choosing the CIC model, in a 2012 survey (Mulkerrin & Gaughan 2013). The other two top reasons were investors, wanting employees/members to participate, and for the founder to share in the profits (Mulkerrin & Gaughan 2013).

Moreover, only handful of company-by-share CICs have paid dividends since the CIC model was created (CIC 2013), only two prior to 2010 (BIS 2010a). Most CICs limited by share cited lack of profit as their key reason for not paying dividends, especially with the cost of a share issue at an estimated £50,000, in the recent survey of CICs (Mulkerrin & Gaughan 2013).

The government considers this a poor result (BIS 2013). It has attributed this poor result to 'issues with the [CIC] model' (BIS 2013), which seems 'unattractive [to investment] in its current form' (BIS 2013). Over the last few years, it has identified two main issues with the model: caps set too low to attract investors, and an overly complex dividend structure (BIS 2013; BIS 2010a; HM Treasury 2013). Certainly, most CICs recently surveyed considered the caps complex, and a key drawback for the CIC by share model (Mulkerrin & Gaughan 2013).

To fix the problem, the CIC Regulator has undertaken two rounds of consultation with the social enterprise sector and lenders – first in 2009, then again in 2013 (BIS 2013; BIS 2010a). The first round resulted in the significant raising of the dividend caps, described earlier (BIS 2010a). The caps were also unhooked from the Bank of England rate, which had been so low that CIC dividend rates barely exceeded debt financing rates, and which also locked CIC investors into low dividends in perpetuity (BIS 2010a). CIC company-by-share registrations spiked following the changes (CIC 2011), some of this fuelled by conversions from other legal forms (CIC 2011). But the spike was short-lived, and by 2013, the Regulator stated that the revisions to the dividend caps had not worked (BIS 2013). The 2010 changes also included raising the caps for interest payments on performance-related loans (BIS 200a). CIC had rarely used this form of financing prior to 2010, and by 2012, take-up was still very low (Mulkerrin & Gaughan 2013; BIS 2013). The CICs themselves reported the raised dividend caps to be helpful – several CICs said the changes had helped them get external investment for the first time (Mulkerrin & Gaughan 2013).

The second round of consultations resulted in significant simplifying of the dividend cap; the cap on dividends per share was eliminated altogether (BIS 2013). As described in Section 4, the only remaining cap remaining is the 35% on aggregate annual profits, which was not raised. The changes not only simplify the cap, they also effectively increase returns for investors in profitable CICs, especially if they have few shareholders (BIS 2013).

The Regulator resisted pressure to raise the aggregate cap on the grounds that raising it would undermine the 'primacy of community benefit' (BIS 2013). She also resisted lenders' pressure to raise the 10% cap on performance related loan interest, saying she felt the cap was needed to prevent circumvention of the asset-lock (BIS 2013). Lenders had argued that performance-related loans were generally high risk (BIS 2013). The Regulator expressed confidence that the new changes would be enough to ensure that the "CIC model is better able to complete against ordinary companies who do not have such restrictions" (BIS 2013).

Some participants in each of the two rounds of consultations opposed the changes (BIS 2010a; BIS 2013). They argued on both occasions that these changes would dilute the CICs' social purposes, and its protection, and make CICs more like commercial companies. In her response to the second round of consultation, the Regulator said she was "content that this will not happen" (BIS 2103).

It is too early to tell whether the new dividend structure will achieve its desired results. A more general question is whether there, in fact, is a point of balance at which the CIC will sufficiently attractive to equity investment, yet fully retain its social purpose credentials and brand.

The Social Investment Market

While the government works to make the CIC share model more attractive to investors and social enterprises, it acknowledges that the social investment market meant to supply CICs with most of their equity funding remains 'challenging' (HM Treasury 2013). The introduction of CICs does not appear to have spurred the growth in social investment that government had hoped. Yet the government claims progress on this front. It says that the U.K.'s social investment market has grown rapidly, from 'almost nothing' in 2000 to $165 million in 2010(HMG 2013; HM Treasury 2013). At least some of this growth can be attributed to the government's own efforts; it has created multiple investment programs, including one that uses a portion of the money in dormant U.K. bank accounts (HMG 2013; HM Treasury 2013). In July 2010, it announced plans to proceed with the establishment of the Big Society Bank, a wholesale financial organization that will invest in financial intermediaries in the social investment market, increasing access to finance for social enterprise (CO 2010). Major banks have also contributed to programs (HMG 2013; HM Treasury 2013).

Other Strategies

The government is also pursuing other strategies to support charities and social enterprises, including CICs. The government announced in its 2013 budget that it would subsidize private investment in these organizations through tax breaks for investment charities, bencoms and CICs (HM Treasury 2013).[130] The final form of these tax breaks is yet to be decided, pending results of another consultation.

5.8 What Attracts Organizations to the CIC Model?

There is relatively little research exploring why social enterprises choose the CIC model over other legal forms. As already noted, what evidence exists suggests that better access to external financing seems to be a significant reason for many social enterprises – it was one of the three top reasons for CIC companies-by-share in choosing a CIC, according to a recent survey (Mulkerrin & Gaughan 2013). In another 2007 survey of early adopters, just under half the respondents cited access to funding as the main opportunity the CIC opened up (Nicholls 2010).

[130] See also September 5, 2013 update at: http://www.hempsons.co.uk/news/charities-and-social-enterprises-updates/. Retrieved December 6, 2013.

But other reasons clearly figure. The other two top reasons CIC companies-by-share in the recent survey chose the CIC model were: wanting employees/members to participate, and for the founder to share in the profits (Mulkerrin & Gaughan 2013). In the 2007 survey, 25% of CICs cited ‘strategic fit’ with the organization’s objectives as their reason for choosing a CIC (Nicholls 2010), while another 23% cited their community objectives , and 13% said they chose the CIC because it was more flexible than a charity (CIC Regulator 2007, cited in Nicholls 2010).

An in-depth qualitative study of four charities that set up CIC trading arms in 2007 sheds some light on why charities might choose CICs as trading arms (Chew 2010). Each of the charities had been already trading (in different fields of activity) but had decided to set up a separate, incorporated trading arm for their activities. The reasons for creating the trading arm were many. Economic reasons were prominent: the desire to diversify income sources, to reduce reliance on grants and donations, and to sustain charity operations (Chew 2010). But separating out the charities’ social enterprises was also thought to strengthen the charity’s strategic position, and to better adapt the charity to the increasingly competitive funding environment (Chew 2010). In addition, the charities felt a trading arm would give legal protection to both their trustees, and to the CIC’s boards of directors, would allow the charities to focus on their mission, and allow them to remain independent of both state and private sectors (Chew 2010). They did not set up their CIC to compete for contracts to deliver public services.

The charities thought the CIC legal form was a good fit for their trading arms because, as respondents put it: “We wanted to trade legally and efficiently and at the same time make it entirely transparent that our commercial activities are for the benefit of the charity and not for an individual”; “We needed to demonstrate to the public the purpose of this CIC, which supports the charitable objectives [of our organization]”; ”the CIC model [provides] legal linkage with the charity and its mission…any assets and surpluses in the CIC go back to the charity as its parent organization” (Chew 2010). Respondents also felt that because of its linkage with the charity’s mission, the CIC model reduces mission drift for the charity (Chew 2010).

None of the charities saw their CIC trading arm as either solely to make money, or to directly sustain the parent organization’s charitable purposes: their objectives were mixed (Chew 2010). Nor were the CICs completely financially independent – two charities had provided grants to their CICs during their first two years to meet their operational needs (Chew 2010). The charities reported some clash between the operating cultures of the parent charity and that of the business-oriented CIC, and two charities felt that the charity’s voluntary ethos and charitable values would be eroded. However the bespoke features of the CIC would help avoid mission drift in the CIC (Chew 2010).

5.9 Conclusion

Nine years after its inception, the U.K. CIC is widely considered a success in terms of interest and take-up among U.K. social enterprises, largely new organizations seeking a legal form. Only a small minority of these organizations have opted to become for-profit CICs, while the large majority appear to be organizations operating in traditional fields of activity in the Third Sector – the U.K.'s broad category of not-for-profit and low profit social purpose organizations, which also includes charities.

CICs were intended to foster social enterprises by providing a legally secured structure for their social purposes combined with relatively broad freedom to operate as a business, including the opportunity to raise equity as well as other forms of financing. At the same time, the government also had other reasons to create and promote CICs. It hoped that CICs would spur development of the embryonic social investment market, which might be attracted to businesses that had 'locked' social goals but yet paid some returns on investment. It also saw the CICs as desirable quasi-non-profit vehicles to deliver public services, and to receive services being spun-out from the public sector, preferable to outright privatization of these services.

The evidence to date suggests the Third Sector organizations have embraced CICs to some extent because they thought that CIC status would help them access traditional government and foundation funding as well as commercial loan financing at better rates. CIC status also makes it easier for them to contract with the government to deliver services, although the new Charitable Incorporated Organization may also satisfy some of this need. More broadly, though, CIC status appears to have appealed because, as intended, it has given them a clear social purpose 'brand' (and the possibility of generating some income internally) which the company limited by guarantee form by itself could not. The CIC's 'brand' value also seems to drive its appeal as a trading arm for Third Sector organizations, compared to the alternative of a regular for-profit company, since the financial benefits of choosing a CIC over a regular for-profit are the same given U.K. Gift Aid rules.

In terms of increasing the social enterprise sector's access to financing, especially equity financing, however, the CIC has yet to realize the government's hopes. CIC status may have made it easier for organizations to raise revenue through government contracts, but it does not appear to have helped much in accessing traditional funding, debt financing, or, most important for the government, equity financing. Access to funding is a serious chronic problem for CICs, as for the Third Sector, and small and medium business sector generally. The CIC has therefore not been a catalyst for development of a social investment market either. Government efforts to increase CIC attractiveness to equity investors have so far failed, though it is too early to tell the effects on investors of its most recent changes to the dividend cap(s). Moreover, raising caps higher risks diluting the CIC's 'brand' appeal as a social purpose entity. The government's recent decision to offer tax breaks to investors in CICs and other Third Sector entities, indicates the government is now using new roads to bring financial resources to the social enterprise sector.

Section 6: Lessons for Canada from the U.K. Experience

6.1 CICs and the legal problem for social enterprises

Prior to the introduction of CIC-type legal forms in the U.K. and Canada social enterprises in both countries used legal forms almost none of which were designed for social enterprise. While social enterprises in both countries have been able to operate under these legal forms, nonetheless the legal forms have not fit all that well with the basic hybrid structure of social enterprises, even if they have worked well for some/many individual enterprises.

Some of the ways in which the legal forms have not fit well are similar in both countries. For Canadian social enterprises the core difficulty is that the legal forms that place no restriction on income generation (profits) and sources of financing make it challenging for social enterprises to pursue social ends (the for-profit company, for example), while the legal forms that legally protect the enterprise's social ends – primarily the non-profit corporation and charities – provide only limited opportunities to earn business income, and to access financing sources such as equity. Some Canadian charities, and to a lesser extent non-profits, find ways around these limitations – by setting up arms-length subsidiaries, for example – but at considerable cost and effort. U.K. social enterprises that eschew a for-profit corporate form also face restrictions on earning business income, and accessing equity financing, and some find similar ways around these limitations.

But a key additional difficulty for U.K. social enterprises has been the absence of a legal form like the North American non-profit corporation, that can legally secure a social enterprise's social purposes. Most legal forms in the U.K. do not legally protect a social enterprise's income and/or assets from being distributed into private hands. Only in U.K. charities – until recently a status rather than a legal form – are the organization's assets and income completely protected against such distribution. U.K. Third Sector social enterprises find ways around this limitation by writing their social purposes into the articles of existing legal forms, such as the company limited by guarantee. But these articles are reversible, and the CLG carries the 'taint' of profit for some.

The differences between the two countries' legal regimes mean that the U.K. CIC solves one problem that Canada does not have, since it already has the non-profit corporate form. Non-profit corporations are expressly designed to serve social purposes. (Non-profits are not completely asset-locked in some provinces, where assets can pass into private hands at the non-profit's dissolution). For U.K. Third Sector organizations, the CIC form now allows them to add a clear social purpose 'brand' or credential to their corporate incorporation, most commonly the company limited by guarantee.

It might appear, therefore, that the CIC/C3 form will not appeal to those Canadian organizations that do not want a for-profit type organization. (As discussed earlier, charities in both countries are ineligible to become CICs or C3s). However, as we saw in Section 2, it has become increasingly difficult for Canadian non-profits to generate the income/profits many need to grow (or sustain the full range of their social purposes). The recent CRA ruling on non-profit profits – the import of which is admittedly disputed – would appear to make the non-profit form increasingly unattractive to new social enterprises. Add to this the non-profit corporation's governance restrictions for individualistic social entrepreneurs, and it could be suggested that some cash-strapped young Canadian social enterprises might find the CIC/C3 form more appealing than the non-profit form. As CICs/C3s, they would have a social purpose 'brand' – albeit a new and unfamiliar one – and also gain potential access to new forms of financing such as social investment equity. On the other hand, Canadian C3s and CICs are taxable.

6.2 CICS and the financial difficulties for social enterprises

This brings us to the second main problem for social enterprises that both the U.K. and Canadian CIC models are hoped to help solve: increasing social enterprises' access to financial resources, especially social investment. As discussed in Sections 2 and 4, organizations in the U.K.'s Third Sector and in Canada's non-profit sector face increasing pressure to find income from new sources. The result within the not-for-profit sectors in both countries is a 'drive to trade', with organizations relying increasing on income from fees and business activities. In addition, new social enterprises with broader social purposes report great difficulty accessing the finance or financial resources they need to survive and grow.

In the U.K., CICs were intended to increase social enterprises' access to equity finance in particular, by permitting capped dividends high enough to attract social investors. As discussed in Section 5, this intention has so far gone unrealized, with relatively few share corporation CICs being registered, and few CICs accessing equity financing or issuing dividends. The government has revised its dividend caps upwards twice to entice social investors to CICs; its first revision did not succeed, and it is too early to tell whether its second changes will be different. The U.K. experience with increasing social enterprises' access to financing through the CIC model does not, therefore, bode that well for Canadian C3s and CICs. However, the B.C. dividend cap (40%) is set somewhat higher than even the new U.K. cap (35%), and Nova Scotia has yet to issue regulations specifying the dividend model for its CICs.

6.3 Further Differences

As discussed in Sections 4 and 5, the U.K. government has had its own additional reasons for promoting CICs. In particular, it has promoted CICs to support its policy of outsourcing public service delivery or 'spinning' services out altogether to social enterprises and mutual associations (employee-owned organizations). In this the government seems to have had some success. About half of all Third Sector trade now consists in contracting with government, and many CICs were created precisely to enable such trade, either by the government itself or by Third Sector organizations, including charities. In Canada, however, this niche is already occupied by non-profit corporations and charities. A major impetus for U.K. growth of CICs therefore seems to be missing in Canada.

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End Notes

[i] The federal *Income Tax Act* [ITA] does not refer to "non-profit" specifically, but Section 149(1)(l) exempts from federal income tax organizations that:

(a) are not charities
(b) are organized exclusively for social welfare, civic improvement, pleasure, recreation or any other purpose except profit
(c) in fact are operated exclusively for the same purpose for which it was organized or for any of the other purposes mentioned in (b)
(d) do not distribute or otherwise make available for the personal benefit of a member any of its income (unless it is an amateur athletics organization) (CRA 2001).

[ii] For example, the CRA has ruled recently that non-profits cannot hold shares to earn income from property (Drache 2013; Drache 2012), or use accumulated funds for long-term investments (Tzannidakis 2013; Broder 2010). Generally, the CRA has been suspicious of large reserves of property (Tzannidakis 2013). The CRA has also strictly interpreted the non-distribution requirement, prohibiting non-profits from making loans to members, shareholders or non-exempt persons, for example, see Drache (2012a).

The CRA has allowed non-profits to accumulate funds from activities, or receive contributions by members, gifts, grants, in order to acquire capital property, but has not allowed non-profits to receive non-incidental income from (building) naming rights (Drache 2013a).

[iii] In determining whether a nonprofit has violated the 'except profit' criterion, the CRA considers four general characteristics of the case:

a. there is trade or a business in an ordinary sense
b. goods or services are not restricted to members and their guests
c. the business is operated on a for-profit basis rather than a cost-recovery basis
d. the business is operated in competition with taxable entities carrying on the same trade or business (CRA 2001).

The recent CRA interpretation would apply to (c).

[iv] Qualified donees include: charities, Canadian municipalities, and public bodies performing a function of the federal government, Low cost housing corporations for the aged. Prescribed universities outside Canada; Her Majesty in right of Canada or a province; andThe United Nations and its agencies.

[v] A *related business* is either one run by volunteers (90% of workers), such as an Opportunity Shop, or is a business linked to a charity's purpose and subordinate to that purpose (CRA 2003; Carter & Man 2008). (Case law on what counts as a 'related business' is inconsistent (Bridge & Corriveau 2009)).

a. To be linked, a business must be either: 'a usual and necessary concomitant' of a charity's programs (e.g. a hospital parking lot); an offshoot of a charitable program (e.g. church sales of recorded church services, for a small fee); one that uses excess capacity (e.g. charging for after-hours use of facilities; or one that involves the sale of items that promote the charity (e.g. T-shirts) (CRA 2003; Carter & Man 2008; Corriveau 2010). It is not enough that the business direct all its profits to the charity (Corriveau 2010).
b. To be subordinate, a business must be subservient to a dominant charitable purpose, as opposed to becoming a non-charitable purpose in its own right (CRA 2003). The CRA uses a range of considerations to determine when a business is subordinate. For example, the CRA expects that the first call on any business profits should go to the charity, rather than to growing the business (CRA 2003; Carter & Man 2008).

[vi] Specifically, 'charitable CED businesses' can:

1. Operate businesses to relieve unemployment, typically by providing training, temporary employment and placement services (70% or more of employees to be from the target group)(CRA 2012;Corriveau 2012) . (Since 2012, these businesses are called *on-the-job training*). These businesses cannot provide permanent jobs for individuals (Corriveau 2010).
2. Operate *social businesses* for individuals with disabilities (all employees to have disabilities, except supervisors and trainers)(CRA 2012; Corriveau 2012)
3. Provide grants and loans to organizations and businesses serving any of the four populations. Activities here can range from start-up loans, micro-loans and loan guarantees for businesses that further CED charitable purposes, to providing individual development accounts for individuals (Man et al 2012; Bridge u.d.)
4. In depressed or 'economically challenged' communities, create services or businesses providing affordable housing or community or cultural facilities; preserve heritage properties and natural sites; support or operate businesses that build or retain the community infrastructure needed for the community to be viable (including general stores, banks, post offices or health services); actively promote agriculture and craftsmanship (Bridge u.d.)
5. Make Program Related Investments (PRIs) in programs and business activities serving the four populations. PRIs are non-conventional investments that may or may not generate a return on the investment, but that are made for other reasons. They are often made by charitable foundations (CRA 2012; Man et al 2012).
6. Set up or support community land trusts. (Bridge, u.d.; CRA 2012).

[vii] Under the new rules, CED charity businesses, including foundations, can:

1. Make PRIs in shares and leases of land and buildings, in addition to loans and loan guarantees previously allowed (CRA 2012; Man et al 2012).

2. Make PRIs in organizations other than the *qualified donee* organizations previously allowed. This effectively broadens the kinds of organizations that foundations can invest in. The most significant *qualified donee* organizations are: charities, Canadian municipalities, and public bodies performing a function of the federal government. Charities making PRIs must retain ongoing direction and control over their investments, including any business in which they hold shares. Foundations making PRIs in the form of shares cannot acquire a controlling interest in the business, since they are not allowed to run businesses.
3. In addition to making loans and loan guarantees for activities to relieve poverty, as previously allowed, make loans and loan guarantees for education and any other purpose that benefits the community.

[viii] In the early 2000s, government statements and surveys measuring social enterprises defined social enterprises as organizations requiring social objectives, with legal restrictions on profit distribution, and earning at least 50% of income from business activity (Teasdale 2010; Teasdale Lyon & Baldock 2013). In effect, 'social enterprises' were limited to not-for-profits, or to cooperative-like organizations that restricted or prohibited profit distribution. More recently, however, the government's survey definitions have dropped restrictions on profit-distribution, and now define social enterprises as enterprises generating at least 25% of income from trading (for not-for-profits), and distributing no more than 50% of profits to investors in any one year (BMG 2013; Teasdale, Lyon & Baldock 2013).

[ix] U.K. charities, like Canadian charities, have to pursue one of certain number of charitable purposes, meet a 'public benefit' test, and not distribute any profits to individuals for personal gain (the non-distribution rule) (CC 2013). Nor can their assets be distributed to private individuals on dissolution (CC 2013). In return charities enjoy tax exemption, and can receive donations and issue tax receipts (CC2013).

[x] U.K. law allows three types of charity trading:

- Primary purpose trading. This is trading which contributes directly to the charity's stated charitable purpose (CC2007). If the charity's purpose is to advance education, for example, the charity can only trade services connected to education. Government examples of primary purpose trading include: a care home charging to provide housing and care services for elderly people; a charity for the disabled selling products made by its beneficiaries, or a charitable theatre selling tickets for its production (CC2007). Primary purpose trading also includes social businesses and employment training businesses, which are counted as charitable activities in Canada under the CRA's community economic development tax rules (see Section 2) (CC2007).

- Ancillary trading: selling goods and services that support primary purpose trading -- for example, selling food and drink to audience members in the café of a theatre.

- Non-primary purpose trading: trading that is that is not directly connected to their charitable purposes, in order to raise revenue for the charity.

[xi] Most U.K. trading subsidiaries raise money through loan financing from their parent or commercial lenders, from share capital from their parent, or from retained profits (LawWorks 2011; CC2007). Although retained profits are taxable, they may be necessary when the enterprise relies on commercial loans (CC2007). Trading subsidiaries can also raise funding through joint ventures with commercial investors (uncommon (CC 2007), or through equity investment through social investment funding sources such as the U.K.'s Social Stock Exchange, which allows trading of securities in social enterprises (LawWorks 2011). The Charity Commission encourages this (CC2007). But the Commission concedes that charities will find it difficult to attract equity investment from conventional equity markets, and recommends they seek loans from the charity's supporters or commercial banks (CC2007).