



2.8 Operating an unrelated business within your charity

The CRA's Policy Statement CPS-019 What is a related business? details the nuances of when a social enterprise can be operated within a charity, and when another structural option (i.e. a taxable corporation) must be chosen. This document is 'must' reading for charities considering or engaged in social enterprise.

'Social enterprise' has, as yet, no legal meaning in Canada. The CRA guidance therefore refers to 'related' and 'unrelated' business. Related business can be operated within a charity. Unrelated business cannot. The difference between the two is a great source of misunderstanding for social enterprise operators. Most believe that they are operating a related business. Many times, they are not.

Many charities erroneously assume that as long as the profits are flowing back to the charity's good works, then the enterprise can be operated legally as a project within the charity. This is called 'the destination test'... and would hold true if the charity was based in New Zealand!

Canadian social enterprises need to dig deeper, ensuring that they are operating a related business. CRA defines 'related businesses' as two kinds: 1) businesses that are run substantially by volunteers; or 2) businesses that are linked to a charity's purpose and subordinate to that purpose.

If the social enterprise is 90% volunteer-run, then the tests below for linkage and subordination need not be considered.

'Linkage' cannot be claimed merely by the fact that the profits from a social enterprise are directed to a charity. 'Linkage' to the organization's charitable purpose means that the

business must meet one of the following tests. To be considered related, the business must:

1. Be a usual and necessary concomitant of charitable programs (e.g. a hospital parking lot, a university bookstore, a museum gift shop); or
2. Be an offshoot of a charitable program (e.g. a church that records and sells choir recordings); or
3. Represent a use of excess capacity (e.g. charging for parking lot use during hours of closure, or renting out event tents when not being used by the charity); or
4. Involve the sale of items that promote the charity and its objects (e.g. calendars, T-shirts, etc.).

All of the examples given above are CRA's own examples. With respect to item #3 (excess capacity), it is of interest to note that CRA's examples are of excess assets, and not staff time... so we have no clarity on what percentage of staff time would be considered an acceptable 'linked' use for social enterprise activities.

Many organizations define 'linkage' far too loosely. They assume that if the social enterprise relates to the clients that they serve in some way, then the enterprise is a related business that can therefore be operated within the charity. This is not the case – at least one of the four areas of linkage outlined above must be demonstrated in order for the charity to use the linkage argument.

'Subordination' means that the business activity must:

1. Receive a minor portion of the charity's attention and resources; and
2. Be integrated into the charity's operations, rather than acting as a self-contained unit; and
3. Not dwarf the charity's decision making so that charitable goals take a backseat to the enterprise's; and
4. Not involve private benefit.

All four of these areas of subordination must apply to the social enterprise in order for it to be considered a related business.

If the social enterprise is not substantially run by volunteers, and if linkage and subordination cannot be demonstrated, then the charity is operating what CRA calls an unrelated business.

In the case of unrelated business, the charity is advised to establish a separate legal entity (usually a taxable corporation), which must operate at absolute arms' length from the charity. This includes a separate Board of Directors, ledger, bank account, etc.

The separate legal entity that holds the unrelated business cannot benefit in any way from the charity that owns it. To err on the side of caution, charities should enact absolute separation of staff, equipment, and sundry supplies; or a clear paper trail that shows the corporation paying fair market value for use of the charity's resources, such as rent.

An unrelated business cannot be run as a 'project' within the charity, but must be established as a completely separate legal entity, remitting corporate taxes on net income derived from social enterprise activity. The corporation can donate up to 75% of its net profits to the charity, and only pays income tax on the remaining net profit after the donation is made.

When an unrelated business is detected by CRA within a charity, the fine is 5% of gross revenues of the venture. Upon the second discovery, the fine is 100% of gross revenues plus suspension of receipting privileges.

(excerpt from BC Centre for Social Enterprise)