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EARNED INCOME FOR FINANCIAL SELF SUFFICIENCY

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Abstract

Finding money is a key of the success of social enterprises. It must be recognized that traditional registered charities and nonprofit organizations have a long history and many operate in a financially sustainable manner through their ability to attract some combination of grants, contributions and donations. However, in response to difficulties in attracting these traditional sources of funding, newer types of social ventures have emerged that seek nontraditional forms of funding such as earned income. Financial sustainability and self sufficiency could be seen as objectives of an organization in the achievement of their social mission. Financial sustainability can be achieved through philanthropy, donations, grants, contribution, subsidy and earned income, but financial self sufficiency can only be achieved through reliance on earned income. Through generating profits from income generating activities and cost recovery, earned income could help financing (in whole or in part) the social mission of a social enterprise. The paper will focus on earned income as a way to achieve financial self sufficiency by examining the various dimensions and issues regarding earned income in Canadian registered charities and nonprofit organizations.

Themes: nonprofit and social economy research, financial self sufficiency, earned income

Introduction

Changing conditions in the external environment are exerting pressure on the voluntary sector in general and charities and nonprofit organizations in particular (Drache, 1998). For example, reduced government funding, a greater need for financial resources to address growing social needs, demographic changes in the Canadian population, increased public demand for accountability, and economic difficulties have changed the context in which social organizations operate (Brouard, 2007), and have taxed their capacity to adapt. With the changing environment, money will become more difficult to get and will need creative solutions.

Finding money is a key of the success of social enterprises. For our purposes, social enterprises are defined as “organizations created to pursue social missions or purposes that operate to create community benefit regardless of ownership or legal structure and with various degrees of financial self sufficiency, innovation and social transformation” (Brouard, Hebb and Madill, 2008, p.11). However, we will limit our discussion to a subset of social enterprises, namely charities and nonprofit organizations.

The purpose of this paper is to study earned income among different options to achieve financial self sufficiency and to examine various dimensions and issues related to Canadian registered charities and nonprofit organizations. The intention is not to discuss use of other legal structure such as for-profit corporation, combination of for-profit and nonprofit corporations, business trust or new form (Carter and Man, 2008; 2009). The paper is an attempt to help practioners with their strategic plan, academics with their research and government officials with policy development.

The paper is organized as follows. The first section provides an overview of types and sources of funding. The next section compares financial sustainability and financial self sufficiency. The following section provides some issues of earned income as part of a business. The last two sections provide analysis of earned income in charities and nonprofit organizations in relation with Canada Revenue Agency (CRA) parameters.

Types and sources of funding

Different types of funding may be available for a social enterprise, namely grants, contributions, other transfert payments, subsidy, rebates, sponsorship, advertising, donations, dues, fees and earned income. Even if they are important, the present paper does not covered fundraising activities (Drache, 1990), partnership (Dart, 2004) or financing activities such as loans and other financial instruments (Mendell and Nogales, 2008) and volunteers work which save money but does not provide cash. Funds come from different sources, such as government, corporations, philanthropist, members and clients.

Grants and contributions are types of voted transfer payments by governments. Grant is "inconditional transfer payment where the eligibility criteria that are applied before payment assure that the payment objectives will be met" and contribution is "a conditional transfer payment in which there are specific terms and conditions that must be met by a recipient before payment is given" (Scratch, 2006, p.1). The contribution is subject to performance evaluation, should be account for and is subject to audit, compare to the grant which is not subject to be accounted for and not normally subject to audit. Other transfert payment is a transfer payment, other than a grant or contribution, based on legislation or other arrangement, and may be determined by a formula (TBCS, 2008). Different government programs allow for subsidy, rebates, for example, forgivable loans, interest cost rebates, low-interest rate or interest-free loan, tax credit, sponsorship, advertising (TBCS, 2008). In Canada, we could cite federal, provincial, regional, municipal and territorial forms of governments as a source for those types of funding. Sponsorship and advertising could also come from corporations, Crown, public or private.

Donations, small and large, are a traditional way of funding for charity and nonprofit organization. Corporations, foundations and individual philanthropists (Brouard and Larivet, 2010) are possible funders. Members could pay association dues or fees. However, in response to difficulties in attracting these traditional sources of financing, newer types of social ventures have emerged that seek nontraditional forms of financing such as earned income. Clients provide funding for the organization with earned income.

Financial sustainability vs Financial self sufficiency

Financial sustainability and self sufficiency could be seen as objectives of an organization in the achievement of their social mission. Boschee and McClurg (2003) indicate a distinction between financial sustainability and self sufficiency. Financial sustainability is the capacity to endure by being able to remain in activity for long time. In comparison, the financial self sufficiency dimension refers to financial autonomy through generating profits from income generating activities. A contrast exists between the dependency model, where an organization is dependent upon funder willingness to provide funds, and self sufficiency model, where the organization is independent of funders by generating their own funds. Boschee and McClurg (2003) find that sustainability can be achieved through philanthropy, donations, grants, government subsidy and earned income, but self sufficiency can only be achieved through reliance completely on earned income. For Boschee (2001), earned income is an essential aspect of social enterprise viewed as social ventures and a primary goal. Various degrees of financial self-sufficiency could be found in social enterprises. Two third of Canadian social enterprises have been found to have a higher level (vs lower) of financial self-sufficiency (Madill, Brouard and Hebb, 2010).

Business and Earned income

With the concept of earned income, the concept of business is central. “In general terms, a business involves commercial activity - deriving revenues from providing goods or services - undertaken with the intention to earn a profit” (CRA, CPS-019, par.4). CRA (CPS-019) and Innes and Boyle (2006, p.33) summarize the criterias generally considered by the courts to determine if an activity is a business activity:

(a) “whether the activity was undertaken with the intention to earn profit;
(b) whether profit and loss were experienced in previous years;
(c) whether the person or organization has any training or expertise; and
(d) whether the person or organization is capable or earning a profit from the activity”.

Even if the determination of a business is a question of fact, CRA (IT-496R, par.7) list some characteristics that might indicate that an activity is a trade or business:

(a) "it is a trade or business in the ordinary meaning, that is, it is operated in a normal commercial manner;
(b) its goods or services are not restricted to members and their guests;
(c) it is operated on a profit basis rather than a cost recovery basis; or
(d) it is operated in competition with taxable entities carrying on the same trade or business".

CRA (CPS-019) recognizes some activities intended to generate a profit but not considered to be businesses: soliciting donations and selling donated goods. Soliciting donations is "not considered to be a commercial activity because donors do not expect any good or service in return for their contributions" (CRA, CPS-019, par. 5). Selling donated goods is "not considered to be a commercial activity because businesses do not depend on donations to create their inventories" but could be considered a commercial activity depending on the level of work done apart from converting a donated assets into cash (CRA, CPS-019, par. 5).

When we refer to earned income, explanations are needed on the concept of net income. Net income / net loss represent the difference between revenues and expenses. When revenues exceed expenses, net income occurs and net loss occurs when expenses exceed revenues. Two approaches could help differentiate a business: profits basis and cost recovery basis. Profits come from income generating activities. The goal is to maximize revenue. A minimum level is to reach at least the break even point, where revenues equal expenses. Cost recovery come from expense reduction generating activities. The goal is to minimize expenses and defray existing costs rather than generate a profit. The impact on the net income will be the same if you increase the revenues or reduce the expenses. However the approach is different and strategies and scope to achieve it will be different too. The parameters set by CRA will be different depending on the type of earned income strategies adopted to operate.

Business and Earned income in Registered Charities in Canada

According to CRA (2008), in 2006, 83,372 registered charities could be found in Canada. The *Income Tax Act* (ITA) does not provide a very comprehensive description of a charity. Charity "means a charitable organization or charitable foundation" (ITA 149.1(1)). Essentially, charitable organizations are active charities and charitable foundations are funding organizations. Three types of registered charities exist: charitable organization, public foundation, private foundation (ITA 248(1)). CRA describes a registered charity as an organization established and operated exclusively for charitable purposes (CRA, 2009a). The courts have consistently reinforced the four categories of objects/purposes of a charity: relief of poverty, advancement of education, advancement of religion and any other purpose beneficial to the community not falling under the other three purposes (Bourgeois, 2002).

Innes and Boyle (2006) summarize three main elements require to qualify as a charitable organization. First, "all of the resources of the organization are devoted to the charitable activities that it carries on itself" (p.8). Second, "no part of the income of the organization may be payable to or otherwise available for the personal benefit of any proprietor, member, shareholder, trustee or settler of the organization" (p.9). Third, "a charitable organization must meet an arm's length and absence of control test with respect to major donors" (p.9).

As funding organizations, charitable foundation doesn't need to carry the charitable activities themselves. They are subdivided into public foundation and private foundation. "Charitable foundation means a corporation or trust that is constituted and operated exclusively for charitable purposes, no part of the income of which is payable to, or is otherwise available for, the personal benefit of any proprietor, member, shareholder, trustee or settler thereof, and that is not a charitable organization" (ITA 149.1(1)). Public foundation means a foundation where more than 50% of its board operating at arm's length and no *de facto* or *de jure* control by a person who has donated more than 50%

of its capital (major donor) (Innes and Boyle, 2006; ITA 149.1(1)). “Private foundation means a charitable foundation that is not a public foundation” (ITA 149.1(1)).

The first benefit of being a registered charity is a complete income tax exemption (ITA 149(1)(f)). A second advantage, a major financial incentive, is the possibility to provide receipts to donors allowing individuals to claim tax credit for charitable donations (ITA 118.1) and allowing corporations to claim deductions in their taxable income calculations (ITA 110.1).

Bourgeois (2010b) mentioned three policy issues invoking business income regarding charities. First, the purpose of a registered charity is to carry out charitable activities, not business activities. This is why they could receive a tax exemption and could issue tax receipt for charitable donations. Second, there is risk factor associated with a business which may be in contradiction with the original charitable purpose. On the other hand, by diversifying the sources of revenue it will reduce the exposure of charities to risk. Third, a charity competing with regular businesses could be considered to have an unfair advantage due to their special tax status.

As part of the general requirements to maintain registration is the problematic rule that a charitable organization (ITA 149.1(2)) or public foundation (ITA 149.1(3)) may only carry on related business activities that accomplish or promote their charitable objectives, and a private foundation (ITA 149.1(4)) must not carry on any business activities whatsoever. The *Income Tax Act* does not really define a related or unrelated business, except to clarify an inclusion (CRA, CPS-019). The term related business is described as “businesses that are linked to a charity’s purpose and subordinate to that purpose” (CRA, CPS-019, par.17).

CRA (CPS-019) identify four forms of linkage and provide some examples: 1) a usual and necessary concomitant of charitable programs with examples such as a museum opening a gift store, a hospital running a cafeteria and a church operating a religious bookstore, 2) an off-shoot of a charitable program with examples such as an heritage village selling flour and a symphony orchestra or church selling recordings of its performance, 3) a use of excess capacity with examples such as churches renting out their parking lots during the week and universities renting accommodation in their student residences during the summer, and 4) the sale of items that promote the charity or its objects with examples such as pens, cookies and T-shirts.

CRA (CPS-019) identify four factors indicating subordination: 1) relative to the charity's operations as a whole, the business activity receives a minor portion of the charity's attention and resources, 2) the business is integrated into the charity's operations, rather than acting as a self-contained unit, 3) the organization's charitable goals continue to dominate its decision-making, and 4) the organization continues to operate for an exclusively charitable purposes by, among other things, permitting no element of private benefit to enter in its operations.

A related business is also "a business that is unrelated to the objects of the charity if substantially all persons employed by the charity in the carrying on of that business are not remunerated for that employment", or, in other words, a business runs substantially by volunteers (ITA 149.1(1)). The expression 'substantially all' is interpreted by CRA as meaning 90% (CRA, CPS-019, par.18). The expression 'carrying on' a business is interpreted by CRA as "a continuous or regular operation" (CRA, CPS-019, par.9). This is important because if a charity is not found to be 'carrying on' a commercial activity at all, then it would not matter if the activity was related or unrelated.

CRA (CPS-019) considers fundraising events as business activities. However, "in practice, they are mostly not affected by the related business provisions because they do not amount to 'carrying on' a business" (CRA, CPS-019, par.12). Factors to divide fundraising event and carry on a business are: 1) "A fundraising event has clear 'start' and 'end' points" compare to continous operations and 2) "A fundraising event of a particular type does not recur with such regularity and frequency that it amounts to carrying on a business" (CRA, CPS-019, par.12).

CRA (1999) interpretation provides some exception regarding community economic development related to 'training businesses', 'social businesses', thrift stores and 'community businesses'. The purpose of 'training businesses' "is to give on-the-job training in vocational skills or more general training in work skills that enhances a person's employability" (CRA, 1999, p.6). Their characteristics are: "classroom training occurs before or accompanies the on-the-job training; the participants are employed in the business for a limited period of time; the charity offers a job placement service to help graduates of the program find work in the labour force; the proportion of workers from the target population in relation to the total number of employees is no lower than 70%, but alternative ratios may be justifiable if considerable supervision is required; and revenues derived from the business do not substantially or consistently surpass the break-even point" (CRA, 1999, p.6).

"Social 'businesses' addres the needs of the disabled and are recent equivalents of sheltered workshops" and "seek to provide employment on a permanent basis" (CRA, 1999, p.7). Their characteristics are: "the work is specifically structured to take into account the special needs of the workers; the workforce is comprised entirely of people who are physically, mentally, or developmentally challenged, with the exception of a few persons with specialized skills required for operating the business; the workers are involved in decision-making for the organization and sit on its board to foster their sense of competence and control over their lives; income derived from the business may pay the workers' wages, but the organization is subsidized, usually by government grants; and the organization provides training that is not only immediately job-related, but which enhances the general skills of its workers" (CRA, 1999, p.7).

CRA (1999, p.7) "recognize the operation of thrift stores and similar outlets as a charitable activity if the stores are located in sections of a community inhabited largely by the poor, if they sell donated goods at low-price, and if they operate on a break-even basis". Another type of businesses, 'community businesses' or "agencies created by a community-based organization to address a social need", "cannot be assumed to be charitable", for example a nursing home (CRA, 1999, p.8).

In case of default to the rules, CRA have adopted a gradual penalty approach involving monetary sanctions, suspensions of privileges and revocation of status (CRA, CSP-B02): first, monetary sanctions of 5% on the gross unrelated business revenue earned in a fiscal period for charitable organization and public foundation or 5% on the gross business revenue earned in a fiscal period for private foundation; second, monetary sanctions increase to 100% and suspensions of tax-receipting privileges for a repeat infraction within five years; third, registered charity status revoked, if continuation to contravene.

Business and Earned income in Nonprofit organizations in Canada

Nonprofit organization is defined as "an organization formed for social, philanthropic or similar purposes, in which there is normally no transferable ownership interest and that does not carry on business with a view to distribution or use of any profits for the pecuniary gain of its members" (CICA, 1992, p.143).

Per the *Income Tax Act* (section 149(1)(l)), nonprofit organizations are "a club, society or association that, in the opinion of the Minister, was not a charity […] and that was organized and operated exclusively for social welfare, civic improvement, pleasure or recreation or for any other purpose except profit, no part of the income of which was payable to, or was otherwise available for the personal benefit of, any proprietor, member or shareholder thereof unless the proprietor, member or shareholder was a club, society or association the primary purpose and function of which was the promotion of amateur athletics in Canada". The paper will limit the discussion to those nonprofit organizations and not all the other special-purpose bodies mentioned in ITA 149.

An organization, who qualify as a section 149(1)(l) entity, will qualify for a complete income tax exemption under ITA Part I and other tax (Parts I.3, IV, IV.1, VI, VI.1) (ITA 181.1(3) and 227(14)). However, they will have to file a return if they are a corporation or under special circumstances (e.g. ITA 149(12)). Other potential preferential tax treatment for nonprofit organizations are related, for examples, to retail sales tax, goods and services tax, property tax and land transfer tax. The consequence for nonprofit organizations of a default in following CRA rules is the possibility of losing the income tax exemption. Where the main purpose of a nonprofit organization is to provide dining, recreational or sporting facilities for its members (for examples a curling or golf club), there is an exception to the exemption to tax investment income (property income and taxable capital gains) in excess of $2,000 as part of a trust deemed to have been created (ITA section 149(5)).

Four issues regarding earned income for nonprofit organizations could be underlined. First, the organization should not be a “charity”. It should be noted that “an association may be considered to be a charity even if it is not a registered charity or if its designation as a registered charity has been revoked“ (CRA, 2001, par.4).

Second, the organization should operate exclusively for a specific purpose. Interpretation based on tax case BBM Canada of what is acceptable or not for a nonprofit organization regarding the “exclusively” concept per CRA is changing and may add more complications to earn income. In a CRA (2009b) technical interpretation (in Bourgeois, 2010c), the tax authority interpretation of the law is that “while an organization may have many purposes, none of those purposes may be to earn a profit […] even if it expects to use or actually uses that profit to support its non-for-profit objectives”. Therefore “CRA accepts that a 149(1)(l) entity can earn a profit […]. However, the profit should generally be unanticipated and incidental to the purpose or purposes of the organization”.

Third, it could be interesting to look at the different purposes for a nonprofit organization and the meaning of those purposes per CRA (2001, par.5).

- “ ‘Social welfare’ means that which provides assistance for disadvantaged groups or for the common good and general welfare of the people of the community.”

- " 'Civic improvement' includes the enhancement in value or quality or community or civic life.",
- " 'Pleasure or recreation' means that which provides a state of gratification or a means of refreshment or diversion."
- " 'Any other purpose except profit' is interpreted as a catch-all for other associations that are organized and operated for other than commercial or financial reasons."

Fourth, no distribution or payment for the personal benefit of any proprietor, member or shareholder should occur. CRA (2001, par.11) specify that "certain types of payments made directly to members or indirectly for their benefit, will not, in and by themselves, disqualify an association from being tax-exempt". Examples are "salaries, wages, fees or honorariums for services rendered to the association, provided the amounts paid are reasonable and no more than those paid in arm's length situations for similar services" and some reimbursement of expenses (CRA, 2001, par.11).

Conclusion

Money is an essential ingredient of success for social enterprises. Looking at the financial self sufficiency, earned income is one option to get money in addition to grants, contributions, sponsorship, donations, fees and dues. Depending if we look at registered charities or nonprofit organizations, Canada Revenue Agency (CRA) set different parameters and if they are not followed, many negative consequences could occur for registered charities or nonprofit organizations, such as monetary sanctions, suspensions of privileges, revocation of status and lost of income tax exemption. Two approaches could help differentiate a business: profits basis from income generating activities and cost recovery basis from expense reduction generating activities.

For registered charities, it is possible for charitable organizations and public foundation to have a related business. A related business is a business that is linked to a charity's charitable purpose and subordinate to that purpose and an unrelated business that is substantially run by volunteers. However, it is not possible at all for private foundation to operate a business. For nonprofit organizations, the purpose is also important and no distribution or payment for the personal benefit of any proprietor, member or shareholder should occur. Therefore in some situations, it is possible to have business activities and earn income. However, caution should be exerciced in the structure and operation of a business to stay within the rules and interpretations by CRA.

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