September 2014

Mobilizing Private Capital for Public Good: Priorities for Canada

Canada's National Advisory Board to the Social Impact Investment Taskforce

MaRS | CENTRE FOR IMPACT INVESTING

Who we are

As part of the June 2013 G8 meeting, an international effort was undertaken to explore the potential for impact investing to accelerate economic growth and to address some of society's most important issues. To continue this exploration and catalyze the development of the impact investment market, the Social Impact Investment Taskforce was launched, chaired by Sir Ronald Cohen.

Under the auspices of that effort, the Canadian National Advisory Board was formed to focus on the domestic policy agenda. The board is composed of 24 thought leaders, including private investors, fund managers, entrepreneurs, academics, and leaders from foundations, non-profit organizations, financial institutions, and impact-oriented intermediary organizations. The board includes members from the 2010 Canadian Task Force on Social Finance, providing continuity with past work.

The group's purpose is to highlight key priorities for Canadian policy-makers, in order to support the growth of impact investing and to provide counsel to the global policy discussion.

This report is the result of a collaborative process. Each member of the board contributes unique perspectives and priorities to this effort. Members of the board have participated in their capacity as individuals, rather than as representatives of their organizations. The report embodies the collective perspectives of the group, rather than the specific viewpoints of each individual.

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Numerous contributors informed the development of this report. Individual acknowledgements are made separately for Part 1 and Part 2 of the report.

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Introduction and Executive Summary

The practice of impact investment (or social finance) is gaining domestic and international attention. Focused on directing private capital into projects and ventures whose aims are to deliver measurable social outcomes, impact investment has the potential to foster innovation in the social sector. It can be used to develop and test new ideas that may effectively tackle social challenges, and to scale up those that work.

Impact investment can spur non-profit, private, and public sector collaboration, to assist individuals and communities to realize greater social and economic outcomes.

BUILDING FROM A RICH HISTORY

Impact investment builds from a robust, pan-Canadian history of investing private capital with the aim of generating financial returns along with positive social, environmental, cultural, or economic impacts. This practice reaches back to the early 1900s, with the emergence of credit unions, and continues through to the present day, with the development of, for example, co-operatives, community economic development initiatives, solidarity finance and the social economy in Quebec, Aboriginal Financial Institutions, micro-finance, public-private partnerships, socially responsible investment (SRI), and corporate social responsibility. Impact investment also builds on efforts to focus philanthropy and public social expenditure on the achievement of specific outcomes.

While there is no hard stop between these concepts and impact investment, the latter emphasizes the importance of impact measurement, and presents new opportunities for multi-sector partnerships in a market that, while still nascent, is driven by an existing network of leaders spanning the country.

Investments can target a range of positive impacts. Throughout this report, the term "social impact" is understood to include economic impacts in depressed regions, and for disadvantaged populations, as well as environmental impacts, in alignment with the Social Impact Investment Taskforce.

> "The Canadian impact investment market is demonstrating positive momentum..."

WHAT IS IMPACT INVESTMENT?

Using the definition adopted by the report *State of the Nation: Impact Investing in Canada*, impact investment embodies three key characteristics:

1. **Investor intention:** Investors seek to allocate capital (debt, equity, or hybrid forms) to investments from which they expect to receive a financial return (ranging from return of principal to market rate returns) and a defined societal impact.
2. **Investee intention:** Business models for investees (whether they are for-profit or non-profit enterprises, funds or other financial vehicles) are intentionally constructed to seek financial and social value.
3. **Impact measurement:** Investors and investees are able to demonstrate how these stated intentions translate into measurable social impact.

Impact investment differs from the most prevalent forms of SRI in that it moves from negative screening (avoiding investments that do not meet certain environmental, social or governance criteria) to investment with the intention to achieve positive social outcomes. Canada's National Advisory Board views impact investment as complementary to public social expenditure and philanthropy.

The Canadian impact investment market is demonstrating positive momentum, surfacing numerous examples of established multi-sector partnerships in which private capital is being used to drive positive social impacts, and with various new initiatives underway.[1]

The Fiducie du Chantier de l'économie sociale, created by the Chantier de l'économie sociale in 2007, is the first patient capital fund in Quebec. The Fiducie is a result of successful collaboration between governments and labour organizations, and responds to the unmet need for long-term capital in the social economy. The fund was initially capitalized by Economic Development Canada with a grant of $22.8 million. Investors (trustees) in the Fiducie include the Fonds de solidarité ($12 million), Fondaction ($8 million) and the Québec government, Investissement Québec ($10 million). To date (December 31, 2013), the Fiducie has authorized over $37 million in investments for 128 social enterprises, and is estimated to have created and maintained about 2,000 jobs.

The Government of Quebec has made direct investments in social economy organizations through Investissement Québec (IQ), an economic development agency and financing corporation. Between 2002 and 2012, the social economy division of IQ invested $27 million, which in turn leveraged $375 million of additional investment with an overall impact of $3.5 billion in the Quebec economy. This division has the lowest default rate of the IQ.[2]

The Capital for Aboriginal Prosperity and Entrepreneurship (CAPE) Fund is a $50 million private equity investment fund that aims to encourage Aboriginal entrepreneurship and business ownership by providing capital, businesses expertise, and mentorship to projects with the potential to deliver both a financial return and a social return.

Indigena Solutions exemplifies how First Nations-driven businesses can attract investors to create impact. Based in Vancouver, Indigena Solutions is a partnership between the Tsawwassen First Nation, Accenture, and the CAPE Fund. Indigena opened its first delivery centre in July 2012, delivering information technology and business support services at competitive prices. Indigena's services and workforce model align with its belief in community transformation through creating jobs that allow people to live and work in or close to First Nations communities, while leveraging technology to enable First Nations socio-economic development.

Founded in 1946, Vancity has grown to become Canada's largest credit union, serving over 500,000 members at about 60 locations across British Columbia, with more than $17 billion in assets under management. Vancity delivers competitive returns to its members while targeting social, economic and environmental impact through loans and investments. Vancity's impact lending and investing is focused in the areas of: Aboriginal communities; energy and environment; impact real estate; labour unions and members; local, natural and organic food; microfinance; and social enterprise. Vancity is a member of the Global Alliance for Banking on Values, and is a widely recognized pioneer in the areas of social finance, and supporting social enterprise.

The Immigrant Access Fund (IAF) was launched in Alberta in 2005. It provides micro-loans of up to $10,000 to immigrants who face barriers to accessing mainstream credit, for example, because they are unemployed, have no credit history, or lack collateral. These loans can be used to finance licensing and training, and ultimately aim to help immigrants enter the workforce. The IAF has invested over $5 million in loans, with an average loan amount of $6,500. The annual interest rate is set at the Bank of Canada prime rate plus 1.5 percent. Principle repayments and interest are recycled back into the fund. Loan capital for IAF Alberta is provided by donors and through lines of credit secured by guarantees from members of the community. The IAF is being expanded across the country, with support from the Government of Canada's Foreign Credentials Referral Office. IAF Saskatchewan was launched in 2012, with loan capital provided by donors and the Government of Canada.

Under Ontario's Social Enterprise Strategy, a number of initiatives are being advanced, including a $4 million Social Enterprise Demonstration Fund that will be used to pilot new social finance projects and to unlock additional capital for social enterprises, and a call for Social Impact Bond (SIB) ideas.

The Canadian Alternative Investment Cooperative (CAIC) was created in the early 1980s and now manages $6.7 million in capital. CAIC invests in non-profit organizations, charities, cooperatives and social enterprises, providing: mortgages for community-based projects; loans for social and affordable housing initiatives; and loans and equity investments for social enterprises.

CAIC invested in YWCA Halifax in 2013. The YWCA's vision was to build a daycare and office space. After investments were made by the YWCA and the Government of Nova Scotia, CAIC provided a second mortgage. CAIC facilitated the deal by taking the riskier position as a second lender, without charging the interest premiums normally associated with such a position. CAIC reports that the investment is meeting their financial expectations, and full enrolment at the daycare suggests a strong social return.

Figure 1: Canadian Task Force on Social Finance 2010 Recommendations

Capital Mobilization				Enabling Tax & Regulatory Environment		Investment Pipeline
Foundations should invest at least 10% of capital in impact investments by 2020	Government should partner with investors to establish a national impact investment fund	Develop new financial products, including SIBs, Community Bonds & Green Bonds	Mobilize the assets of pension funds in support of impact investing	Modernize frameworks governing non-profits & charities; explore hybrid corporate forms	Explore tax incentive options	Make SME business development programs more accessible to social enterprises
• Education & peer-to-peer learning • Regulatory & fiduciary clarification • Reporting on MRI activity	• National fund of funds with a public first loss capital investment of $20M/year over 5 years • Build & strengthen regional funds	• Clarify rules on the public sale of Community Bonds by non-profits • Pilot a Green Bond • Pilot a SIB	• Clarify fiduciary duty • Mandatory disclosure of responsible investing • Mitigate investment risk through guarantees & credit enhancement	• Establish a profits "destination test" for related businesses run by charities & non-profits • Examine the need for a hybrid corporation	• Establish a tax working group & consider tax incentives for: - Impact investors - Social enterprises - Social hires	• Expand eligibility for SME services • Target services to social enterprises • Build a network of regional hubs supporting social enterprises

PART OF A BROADER IMPACT INVESTMENT AGENDA

In 2010, the Canadian Task Force on Social Finance made seven recommendations, addressed to governments, foundations, pension funds, entrepreneurs, non-profit organizations (NPOs), and others, focused on mobilizing new sources of capital, creating an enabling tax and regulatory environment, and building a pipeline of investment-ready social enterprises (summarized in Figure 1).[3] These recommendations remain relevant. The growth of the impact investment market will require all of these actors to come together, often with the help of intermediaries, to design new products, policies, and impact measurement methods, and to galvanize both supply and demand side development.

Canada's National Advisory Board to the Social Impact Investment Taskforce, launched by the G8, has built from these recommendations, focusing on priorities that have the potential to be catalytic in the short term, as part of a longer-term, more comprehensive impact investment strategy.

ORGANIZATION OF THE REPORT

The National Advisory Board has identified two priority areas:

1) **Addressing legislative and policy barriers to social entrepreneurship and impact investment in the non-profit and charitable sector, with a focus on the *Income Tax Act*; and**

2) **Encouraging impact investment through "catalytic capital" measures.**

Parts 1 and 2 of this report describe key barriers, opportunities, and recommendations in each of these areas. Part 1, developed with guidance from an expert working group, is addressed primarily to federal ministers and officials from the Department of Finance, the Canada Revenue Agency and the Department of Employment and Social Development. Some recommendations are addressed to provincial governments. Part 2, developed by KPMG on the basis of interviews with existing and potential impact investors, is also targeted to a federal government audience but is relevant to provincial governments and others.

While focused on governments as critical leaders with the power to unlock capital, support social enterprise development, and catalyze market growth, this report recognizes that expanding the Canadian impact investment market will require action on the part of financial institutions, entrepreneurs, non-profit and philanthropic organizations, intermediaries, and individual Canadians. Governments can create policy frameworks that will enable these other actors to achieve results.

SUMMARY OF RECOMMENDATIONS

PART 1: RETHINKING THE NON-PROFIT / FOR-PROFIT DIVIDE: *INCOME TAX ACT* BARRIERS TO SOCIAL ENTREPRENEURSHIP AND IMPACT INVESTMENT IN THE NON-PROFIT AND CHARITABLE SECTOR.

The rules governing NPOs and charities have not kept pace with the trends of social entrepreneurship and impact investment, which are increasingly regarded as valuable tools for more effectively and efficiently addressing social challenges.

Two distinct sets of recommendations are provided, to better enable social entrepreneurship and impact investment in Canada's non-profit and charitable sector. These recommendations focus primarily on the *Income Tax Act* (ITA) and related guidance. The second set of recommendations also touches on provincial trust law.

RECOMMENDATIONS:

1. ENABLE CHARITY AND NPO SOCIAL ENTERPRISE ACTIVITY.

NPOs and charities are key providers of social services in Canada. They also have a significant economic impact, with a GDP contribution of $35.6 billion, or $100.7 billion including hospitals, universities and colleges (2007 figures), a workforce of over two million, and more than two billion volunteer hours.[4]

To maximize their social and economic impacts, many charities and NPOs are taking an entrepreneurial approach – engaging in revenue generating and capital raising activity to improve financial sustainability, develop and test innovative ideas, and grow successful services to scale. While social entrepreneurship has been evident in the sector for many years, the *Income Tax Act* and related guidance generally do not recognize the value of this activity, and may in some cases inhibit it.

The federal government's Budget 2014 announcement of a consultation on NPOs could provide an opportunity to examine the rules governing revenue-generating activities, in light of the benefits of fostering social entrepreneurship. While not its original intent, this consultation could also potentially provide an opportunity to examine the related business and public benefit rules pertaining to charities.[5]

a) **Allow charities and a sub-set of NPOs with clear public benefit objectives to pursue certain related business activities on an income tax exempt basis, and to pursue other business activities subject to income tax.**

This would provide charities and NPOs with increased flexibility to generate revenue for the purpose of advancing their public benefit objectives, while addressing concerns about unfair competitive advantage and mission drift.

b) **Allow charities to provide a private benefit where it is necessary to achieve a broader public benefit, by clarifying guidance on the public benefit test.**

For example, charities should be allowed to support employer recruitment efforts when this would achieve better employment outcomes for disadvantaged populations and result in reduced unemployment.

2. UNLOCK FOUNDATION CAPITAL FOR IMPACT INVESTING.

The potential for foundations to act as early leaders in Canada's impact investment market is significant. Canadian foundations collectively manage about $45.5 billion (based on 2012 data).[6] While they are required to direct 3.5 percent of their assets into grants each year (to meet their annual disbursement quota), the rest is generally invested with the sole aim of maximizing financial returns. Impact investing offers foundations the opportunity to align at least a portion of their investment portfolios with their charitable objectives.

Existing legislative and policy frameworks allow foundations to make a wide range of impact investments; however, a strong signal from provincial governments is needed, to clarify prudent investor rules and encourage impact investment activity. In addition, certain impact investment opportunities that are currently off-limits for foundations should be permitted through targeted legislative changes.

a) **Clarify that impact investments can be part of a balanced portfolio under current prudent investor rules** (under provincial jurisdiction).

Impact investment opportunities offer a range of risk and return profiles, and can currently be considered alongside more traditional investments as part of a balanced portfolio. In some cases, low correlation to standard financial markets may create an added incentive for considering these investments. It should be noted that prudent investor rules do not exclude consideration of social impact.

b) **Alter trust law to state that, in the case of a charity, a prudent investor <u>should</u> consider social impact** (under provincial jurisdiction).

c) **Allow charities to make below market rate investments, where appropriate to advance their charitable objectives, ensuring that no part of these investments, or any associated opportunity costs, would be considered as gifts to non-qualified donees.**[7]

While it is important to recognize that many impact investments are prudent by traditional financial standards, impact investments for which no return or a below market rate return is expected are sometimes warranted. For example, early stage social enterprises can struggle to attract risk capital and may not be able to offer risk-adjusted market rate returns. In addition, tranched investing, in which certain investors take higher-risk positions that are not necessarily commensurate with return expectations, may be necessary to attract more risk-averse capital to worthwhile projects. This type of investment can be used to complement granting. In many cases, it will also provide a financial return.

In the United States, the Bill and Melinda Gates Foundation has invested in early stage drug, vaccine, and health technology development, in some cases leveraging external capital from private investors that would not otherwise have been available by taking a first loss position or providing guarantees. These investments have been used to accelerate the development of innovative solutions to health challenges that disproportionately affect populations in developing countries, aligned with the foundation's charitable objectives. Grand Challenges Canada, funded by the Government of Canada, engages in similar investment activities. Canadian foundations should be encouraged to play a comparable role in catalyzing investments with positive social impact.

d) Allow charities to invest in limited partnerships (LPs).

Private foundations are prohibited from carrying on a business and other charities are discouraged from doing so. By reason of the legal definition of a partnership, a charity that invests in an LP is considered to be carrying on a business even if it plays no active role in the business, and even though investments are generally understood to provide passively earned income.

The barrier to investments in LPs is problematic from the standpoint of building Canada's impact investment market, as impact investment funds are often structured as LPs. This structure has also been used as a vehicle for investing in SIBs.

PART 2: CATALYZING IMPACT INVESTING: THE OPPORTUNITY FOR GOVERNMENTS

Canada's impact investment market is gaining momentum. It will continue to do so irrespective of government involvement; however, to catalyze this growth, government leadership is needed.

From the Government of Canada's recently launched Venture Capital Action Plan, to the Government of Nova Scotia's Community Economic Development Investment Funds, to the joint investment by the governments of Canada and Quebec in the Fiducie du Chantier de l'économie sociale, initiatives designed to attract additional capital to a variety of markets in support of public policy priorities are not new. These initiatives can take the form of capital matching, credit enhancements, guarantees, and tax incentives.

Outcomes-based financing is another tool available to governments. Service providers can gain access to investment capital based on a government commitment to pay if certain outcomes are achieved, and governments can test or expand services without taking on financial risk.

Government adoption of these tools is recommended, in the context of a broader strategy for building the impact investment market, to ensure a clear vision and comprehensive plan for supporting the development of the supply, demand, and intermediation components of this market.

For example, support for business development, through accelerators or similar programs, is needed to develop a pipeline of investment-ready social enterprises and projects. Similarly, support for contract readiness represents an important complement to an outcomes payment fund, to build the capacity of service providers to engage in outcomes-based financing arrangements.

Given that provincial governments hold many policy levers for market development, and in some cases are already actively engaged, intergovernmental collaboration is advisable.

Input from a wide range of stakeholders would also be beneficial, including investors, social enterprises, NPOs, charities, and intermediaries. Design of the initiatives in Recommendations 3 and 4, in particular, will require input from current and potential impact investors.

KEY RECOMMENDATIONS:

3. ESTABLISH AN IMPACT INVESTING MATCHING PROGRAM, PAIRED WITH APPROPRIATE INCENTIVES.

This could take the form of a fund, capitalized by the government, which would co-invest with private investors, either directly in eligible social enterprises or projects, or in impact investment funds that require additional capital to close a funding round. Similar activities could be undertaken using a pool of grant money and request for proposals approach.

Another option is a fund of funds, which would provide the scale necessary to attract large institutional investors (such as pension funds) to the market, and which could be established through co-investments in partnership with these investors.

Regardless, incentives are recommended to attract new capital, for example, in the form of tax credits or first loss capital.

4. ESTABLISH AN OUTCOMES PAYMENT FUND.[8]

A dedicated fund for outcomes payments would catalyze the development of outcomes-based approaches to service delivery within and outside of governments. The government could specify maximum prices that it is willing to pay per outcome, as has been done in the United Kingdom, enabling the market to respond with innovative solutions.

SUPPORTING RECOMMENDATIONS:

- Provide support for investment and contract readiness, to develop the pipeline of investment opportunities.
- Embed these initiatives in a broader strategy for building Canada's impact investment market, coordinating with all levels of government.
- Engage investors in the design of these initiatives.

CONCLUSION

Public policy challenges – ranging from youth unemployment to homelessness and chronic disease – demand innovation, or they will increasingly represent a drag on the wellbeing of Canadian communities, the economy, and government budgets. Importantly, impact investment – like venture capital for business startups – can provide much needed financing to test and implement innovative approaches to addressing a vast range of social challenges, and can provide an outcomes-focused lens that will help to demonstrate which approaches deliver the best results.

There is nothing illusory about the impact investment market. It is evident in the investment decisions of individual Canadians, in the creation of impact investment funds by financial sector leaders including mainstream banks, and in the demand for capital among social enterprises across Canada.

The Government of Canada, while demonstrating early interest, now needs to determine whether it wishes to position itself at the forefront or at the sidelines of this market. As leaders in this market, governments can accelerate its growth, driving the development and implementation of initiatives designed to improve social and economic outcomes for individuals and communities.

Enabling impact investment and social entrepreneurship in the non-profit and charitable sector, and catalyzing impact investment through capital matching, investor incentives, and outcomes payments, are two immediate priorities for government action.

Canada's National Advisory Board is prepared to provide further advice and support to the Government of Canada, and to provincial or municipal governments, to help advance these recommendations, or related initiatives.

PART ONE

September 2014

Rethinking the non-profit / for-profit divide: *Income Tax Act* barriers to social entrepreneurship and impact investment in the non-profit and charitable sector

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Rethinking the non-profit / for-profit divide:

Income Tax Act barriers to social entrepreneurship and impact investment in the non-profit and charitable sector

Part 1 of this report was informed by Canada's National Advisory Board to the Social Impact Investment Taskforce, launched by the G8, and benefited from the direct guidance of an expert working group.

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RETHINKING THE NON-PROFIT / FOR-PROFIT DIVIDE: *INCOME TAX ACT* BARRIERS TO SOCIAL ENTREPRENEURSHIP AND IMPACT INVESTMENT IN THE NON-PROFIT AND CHARITABLE SECTOR

1. INTRODUCTION

Interest in social entrepreneurship has grown over the last several years, both internationally and in Canada, and new expectations have emerged on the part of interested consumers and investors for products, services and financial returns that are twinned with social impact. It is increasingly recognized that multi-sector collaboration, social entrepreneurship, and impact investment (or social finance) are valuable tools for more effectively and efficiently addressing social challenges.

The *Income Tax Act* (ITA) and related rules governing non-profit organizations (NPOs) and charities have not, however, kept pace with these evolving trends.

This part of Canada's National Advisory Board report proposes two distinct sets of recommendations for amending the ITA and related guidance, as appropriate, to better enable social entrepreneurship and impact investment activities, respectively, in Canada's non-profit and charitable sector. To ensure that these proposals are comprehensive and effective, the second set of recommendations also touches on provincial trust law.

RECOMMENDATIONS:

1. Enable charity and NPO social enterprise activity.

a) Allow charities and a sub-set of NPOs with clear public benefit objectives to pursue certain related business activities on an income tax exempt basis, and to pursue other business activities subject to income tax.

b) Allow charities to provide a private benefit where it is necessary to achieve a broader public benefit.

2. Unlock foundation capital for impact investing.

a) Clarify that impact investments can be part of a balanced portfolio under current prudent investor rules (under provincial jurisdiction).

b) Alter trust law to state that, in the case of a charity, a prudent investor should consider social impact (under provincial jurisdiction).

c) Allow charities to make below market rate investments, where appropriate to advance their charitable objectives. [9]

d) Allow charities to invest in limited partnerships.

2. BACKGROUND

Charities and NPOs fall under shared jurisdiction in Canada. While provinces have primary constitutional jurisdiction over charitable property, the federal government exerts authority through its taxation powers.

Some of the federal rules governing charities and NPOs are embedded in the ITA and associated regulations, while others flow from guidance developed by the Canada Revenue Agency (CRA). The ITA uses the common law definition of charity as the basis for determining requirements for registration and special tax treatment. The CRA is responsible for the administration of the ITA, while policy development related to the ITA generally falls within the mandate of the Minister of Finance.

Provincial legislation governing charities and NPOs, while addressed briefly in the recommendations, is not a primary focus of this report.

2.1 Charities and NPOs

While both operate on a non-profit basis, charities and NPOs are subject to different rules.

Under sub-section 149.1(1) of the ITA, there are three types of registered charities: 1) charitable organizations; 2) public foundations; and 3) private foundations. Charities must serve at least one of four charitable purposes: relief of poverty; advancement of education; advancement of religion; and other purposes beneficial to the community.[10] Charities must be established for the benefit of the public or a sufficient segment of the public, and are required to expend all of their resources on their own charitable activities or on gifts to other charities or qualified donees.[11] Broadly, charities are exempt from the payment of income tax. They also benefit from the ability to provide receipts to donors, who may claim a tax credit or deduction, and are able to accept charitable donations from other charities or foundations. To become a registered charity, it is necessary to apply to the CRA for registration.

NPOs also benefit from an income tax exemption. Unlike charities, they cannot issue charitable donation tax receipts, and are not eligible to receive grants from registered charities. NPOs can operate for any purpose other than profit. A wide range of NPOs exist. Some have a clear public benefit mandate, while others do not.[12] NPOs are not required to register with the CRA.

Charities and NPOs make a significant economic impact. According to a 2007 survey, gross domestic product (GDP) for the core non-profit sector (which includes most charities, but excludes hospitals, universities, and colleges) was $35.6 billion, accounting for 2.5 percent of the Canadian economy. With hospitals, universities, and colleges included, the sector contributed $100.7 billion to Canada's GDP.[13] The sector employs over two million people, and is supported by more than two billion volunteer hours.[14] There are over 80,000 charities in Canada.[15] It is more difficult to accurately count the number of NPOs, given that they are not required to register with the CRA; however, it is estimated that the total number of NPOs in Canada also exceeds 80,000.[16] While exempt from income tax, charities and NPOs do generate tax revenue, for example, through sales tax and employee payroll tax.

2.2 Impact investment and social entrepreneurship

As noted in the introduction, impact investment is understood to involve the investment of capital with the intention to generate and measure positive social impact alongside a financial return – which could range from the return of a portion of the principal to market rate returns. Investees are also understood to have the intention to generate social and financial value, and sometimes operate as social enterprises.[17]

According to the Canadian Task Force on Social Finance, a social enterprise is an "organization or business that uses the market-oriented production and sale of goods and/or services to pursue a public benefit mission." A social enterprise can take the form of a charity, NPO, co-operative, for-profit corporation, or hybrid corporation.[18] Additional information on the structural options available to social enterprises in Canada is provided in Annex A. Recommendation 1 focuses on charities and NPOs.

Realizing the potential of Canada's impact investment market will require action in relation to capital supply and capital demand. This part of the report addresses both, within the context of the non-profit and charitable sector.

3. ITA RESTRICTIONS ON SOCIAL ENTREPRENEURSHIP: REVENUE GENERATING ACTIVITY AND THE PUBLIC BENEFIT TEST

3.1 Charities: Operating a related business

Charities – with the exception of private foundations – are allowed to operate a "related business." This is defined by the CRA as run substantially (90 percent) by volunteers or as linked and subordinate to a charity's purpose.

- Linked: Using profits from the business to advance the charitable purpose does not make the business "linked": the business must either be a "usual and necessary concomitant of charitable programs" such as a hospital parking lot; "an off-shoot of a charitable program," such as the sale of flour from a heritage village mill; "a use of excess capacity," such as renting out university rooms for conferences during the summer; or "the sale of items that promote the charity or its objects," such as T-shirts depicting the charity's logo.
- Subordinate: The CRA has identified four factors that must be considered in determining whether a business is subordinate: 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 purpose by, among other things, permitting no element of private benefit to enter in its operations."[19]

Charitable organizations can create and maintain control over a separate taxable corporation, which could deduct up to 75 percent of net profits in determining income for tax purposes, through donations to the parent charity or another qualified donee.

In this case, any investments in the separate corporation would have to satisfy normal prudent investment rules and no private benefit could be conferred on the corporation by the charity.[20]

3.2 Charities: Public benefit test

A charity must meet two basic requirements. Its purposes must be exclusively charitable, falling into one of the four categories identified in Section 2.1, and it must be established for the benefit of the public or a sufficient segment of the public. To pass the latter test, several sub-requirements must be met, including that a charity must provide a tangible benefit to either the public-at-large or a sufficient segment of the public, determined by the charitable purpose being served, and may not otherwise provide benefits to private individuals, except where they are "a minor and incidental by-product of the charitable purpose."[21]

A private benefit to an employer could be considered as more than incidental. For example, in the case of a charitable job-training program that supports business recruitment efforts, or when the program is targeted to a specific employer, the indirect benefit to the broader public of relieving unemployment could be viewed as too remote relative to the direct benefit conferred on the employer.[22]

3.3 NPOs: Restrictions on earning a profit

Under paragraph 149(1)(l) of the ITA, an NPO must be exclusively organized and operated for an objective other than profit. Recent CRA interpretations of this requirement are stricter than this wording and previous guidance might suggest, equating the intention to earn a profit with being organized or operated with the objective of profit, and seemingly equating surplus with profit.

CRA guidance and interpretive rulings have been varied; however, in one statement, the CRA indicated that an NPO may earn a profit if it is incidental to and results from activities that support its not-for-profit objectives. It further specified that "where an organization intends, at any time, to earn a profit, it will not be exempt from tax under paragraph 149(1)(l) even if it expects to use or actually uses that profit to support its not-for-profit objectives."[23]

NPOs may be allowed, with certain restrictions, to maintain control over a separate taxable corporation; however, CRA guidance to date has been unclear on this point.

3.4 ITA restrictions on social entrepreneurship: The challenge

While charities and NPOs have engaged in business activities for many years, the ITA and related guidance generally do not recognize the value of these activities.

Restrictions on business activity may in some cases limit the growth and impact of successful organizations. The severity of the potential consequences of a misstep, including financial penalties, suspension of tax-receipting privileges, and loss of charitable status or NPO tax-exemptions, may also act as a disincentive to adopt entrepreneurial models. In addition, anecdotal evidence from key informant interviews, and the results of the CRA's recently concluded NPO Risk Identification Project, suggest that a number of registered charities and NPOs have adopted models that expose them to legal risk. They either do not understand the rules or have opted to push the boundaries of these rules in order to innovate.

A case study on Habitat for Humanity, outlined in Annex B, highlights challenges related to current interpretations of the related business rules for charities.

The situation is more severe for NPOs. The Risk Identification Project found that a significant number of the NPOs examined do not meet the requirements under paragraph 149(1)(l) of the ITA. Of the factors reviewed, one of the most serious compliance problems relates to profit-generating activity. It was found that "a significant number" of the NPOs examined are not operated exclusively for a purpose other than profit, and that many engage in a range of activities with profit motives, or carry large reserves generated by non-incidental profits.

Notably, this audit also found that many NPOs view these activities as necessary to further their non-profit missions. It "observed that many in the non-profit sector believe that NPOs must produce a profit for their programs to thrive and for their capital assets to be maintained. In particular, there is a common view that, as long as profits are used to further the organization's purpose, the source of the funding shouldn't matter." [24]

While charities can establish taxable subsidiaries, smaller organizations often lack the capacity and resources to do so. This generally requires, for example, a separate board of directors; separate accounting, banking, reporting and administration functions; and a fair market value exchange for the corporation's use of any charitable resources, such as staff and office space. For NPOs, the rules governing ownership of a separate taxable corporation are unclear.

Finally, current guidance on the requirement for charities to provide a public benefit, and to avoid conferring private benefits, may exclude services that are tailored to helping particular individuals, or based on partnerships with private businesses – even when these services demonstrate significantly improved outcomes aligned with a charitable purpose. A case study on Social Capital Partners, in Annex B, exemplifies this challenge. From a social enterprise perspective, freedom to innovate, with the aim of designing services that will deliver improved social outcomes, is vital.

3.5 ITA restrictions on social entrepreneurship: The opportunity

As key providers of social services, NPOs and charities form a vital part of Canada's social enterprise landscape. To maximize their effectiveness, they require flexibility to develop and test innovative ideas, grow successful services to scale, and ensure financial sustainability.

Imagine Canada has stressed the importance of earned revenue activities, which make up a significant portion of core non-profit revenue (45.6 percent in 2007).[25] Government grants have been uneven and subject to fiscal pressure in the wake of the 2008 financial crisis. Philanthropic giving by individual donors and foundations also slowed, and is only now returning to previous levels. In addition, donor priorities and restrictions often constrain charities' ability to meet core funding needs. Earned revenue can provide a buffer against declines in public and philanthropic funding, and a source of unrestricted funds. It can also help to attract investment capital, and is arguably the only source of non-profit and charitable income with reliable growth potential.[26]

In addition, while direct government funding for social services will continue to be vital across the social sector, governments are signaling increased interest in outcomes-based financing. Except in the case of the Social Impact Bond model – in which investors provide upfront financing to service providers, generally based on a government commitment to pay investors if certain outcomes are achieved – this will create new demand for service providers that are able to manage their cash flow until outcomes payments are received, at least in part through revenue generating activities.

The federal government's Budget 2014 announcement of a consultation on NPOs could provide an opportunity to examine the rules governing revenue-generating activities among NPOs, in light of the benefits of fostering social entrepreneurship.[27] While not its original intent, this consultation could also potentially provide an opportunity to examine the related business and public benefit rules pertaining to charities.

4. RESTRICTIONS ON IMPACT INVESTMENT

4.1 Impact investments

Investments made by charities (generally foundations) are governed by provincial trust law, incorporating statutes, internal documents, and the ITA.

Under the ITA, charities are prohibited from making a grant to an entity that is not a qualified donee. Foregone revenue resulting from an investment that was expected to yield a below market rate return is considered to be a charitable grant. Therefore, the recipient of such an investment must either be a qualified donee or must use the investment for a program over which the investor charity maintains direction and control. If an investment does not fall into these categories, it must be made with the expectation of a risk-adjusted market rate return, and meet standard investment requirements.

Investments that focus primarily on advancing a charity's stated charitable purposes have been termed Program Related Investments (PRIs) in CRA guidance.[28] PRIs may be made with the expectation of receiving no return or a return that is below market rate, and can take the form of loans, loan guarantees, share purchases, or property leases. Generally, a charity could fund PRI activity through grants; however, PRIs offer the possibility of having capital returned, potentially with interest, allowing for reinvestment in charitable activities. In addition to any amount of a PRI that cannot be recovered, the opportunity cost of a PRI could be considered as a charitable expenditure and counted towards a charity's annual disbursement quota, if this quota has not already been met.[29]

Under provincial law, charities are subject to prudent investor rules. Provinces and territories, with the exception of Quebec, have established prudent investor standards in trust legislation. Quebec's *Civil Code* includes rules that parallel these standards.[30] Generally, the prudent investor standard is tied to the management of a balanced portfolio, which contains a diversity of investments, across asset classes and with different levels of risk and expected rates of return. This standard implies that risk must be judged across the portfolio as a whole, rather than by individual investments.[31]

4.2 Investments in limited partnerships

Private foundations are prohibited from investing in limited partnerships (LPs) and other charities are discouraged from doing so.

Paragraph 149.1(4)(a) of the ITA bars private foundations from carrying on a business. While other charities are allowed to carry on a related business, this is defined as either 90 percent volunteer-run or linked and subordinate to the charity's purpose. CRA guidance specifies that, while investments are generally described as providing passively earned income, and are therefore allowable, a charity that invests in an LP is considered, by reason of the legal definition of a partnership, to be carrying on a business "even though the charity plays no active role in the business." [32]

4.3 Restrictions on impact investment: The challenge

According to current ITA rules relating to permissible charitable expenditures, certain impact investments are not possible – specifically, investments into NPOs, co-operatives, social purpose for-profit businesses, hybrid entities, or impact investment funds (which may invest in a range of entities in addition to charities), for which returns are expected to range from zero to below market rate, unless the investor charity maintains direction and control, which is often impractical.

In addition, the barrier to investments in LPs is problematic, from the standpoint of building Canada's impact investment market, as impact investment funds are often structured as LPs. Impact investment funds are of particular interest to foundations, as they offer a relatively cost-efficient opportunity to make large investments that are aligned with their charitable objectives. In contrast, sourcing and evaluating direct investments generally involves a high cost per transaction, and requires resources and expertise beyond the capacity of most foundations. In a few cases, foundations or funds have set up independent trusts as vehicles for foundation investments in LPs. However, this workaround can be costly, onerous, and potentially risky, and has in some instances deterred boards and investment committees from considering impact investments structured as LPs. LPs have also been used as a vehicle for investing in Social Impact Bonds.

While other forms of market rate impact investments (generally termed Mission Related Investments) are currently permissible as part of a balanced portfolio, limited awareness, capacity and deal flow, in addition to risk aversion, may be limiting this kind of activity. Foundation boards tend to invest with a view to maximizing returns and minimizing portfolio risk, focusing on a mix of equities, fixed income, and cash, with some alternative investment assets held for diversification purposes. However, there is a perception that impact investments generally offer lower returns and higher risk. As a result, foundation endowments are often being invested according to conventional asset allocation strategies, rather than in communities.

4.4 Restrictions on impact investment: The opportunity

The potential for foundations to act as early leaders in Canada's impact investment market is significant. Canadian foundations collectively manage about $45.5 billion (2012).[33] While they are required to direct 3.5 percent of their assets into grants each year (to meet their disbursement quota), the rest is generally invested with the aim of maximizing financial returns.[34] Foundations are ideal impact investors because their social missions naturally align with the objectives of impact investing.

Recent studies indicate a discrepancy between targeted and actual impact investments by foundations. In a survey of 66 Canadian foundations, almost three quarters (a sample that may represent those already more inclined towards impact investing) reported five-year impact investment targets of five percent of their endowments or higher; however, less than a quarter had actual impact investment allocations in this range. A related survey found that about 29 percent of foundations surveyed had made Mission Related Investments (MRIs) and 20 percent had made PRIs.[35] It indicated plans to increase MRIs by 29.5 percent and PRIs by 23 percent on average. Current foundation impact investments include about $207.5 million in MRIs and $80.3 million in PRIs.[36]

Many impact investment opportunities are already available to foundations within current policy frameworks. Increasing the uptake of these opportunities could be achieved through clear signals from provincial governments that impact investments can – and should – be considered as part of a prudently invested portfolio.[37]

Permitting foundations to invest in LPs would unlock additional impact investment opportunities. This change would also contribute to the diversification of risk and optimization of returns across foundations' investment portfolios.[38]

In addition, foundations could fill an important gap in the impact investment market by making investments with return expectations that range from zero to below market rate, with the primary aim of advancing their charitable purposes. Changing federal tax rules to allow for this type of investment in any entity (including non-qualified donees) could significantly increase the amount of foundation capital invested in supporting Canadian communities, and catalyze additional non-foundation impact investment. In particular, patient risk capital would be available for early stage social enterprise development, which may not always offer returns commensurate with risk. Foundations could confidently act as first-loss investors, without the high returns that this normally entails, where necessary to attract more risk-averse or finance-first investors to an initiative that would advance their charitable objectives. The longevity of foundation endowments would still be protected, provided that below market rate investments make up only a portion of a foundation's investment portfolio. This would enable a greater proportion of a foundation's assets to work directly in service of its charitable objectives.

Impact investments are attracting increasing interest from Canadian foundations and could become an important part of their investment and public benefit strategies, and a key element of their value proposition from the perspective of donors, governments, and the public at large.

5. RECOMMENDATIONS

Canada's National Advisory Board is confident that appropriate amendments to the rules governing charities and NPOs, in the ITA and related guidance, would accelerate the growth of social enterprise and impact investment activity in Canada. This, in turn, would enhance the ability of NPOs and charities to innovate and contribute to building resilient Canadian communities.

Two sets of recommendations are proposed. Some require legislative change. It is possible that others could be realized, at least in part, through changes to administrative guidance. Two proposals, under Recommendation 2, would require action by provincial governments.

5.1 Recommendation 1: Enable charitable and NPO social enterprise activity

"Over the last decade, the charitable and nonprofit sector has been one of the most rapidly growing parts of the Canadian economy. Yet, there remains a pressing need to ensure the sustainability of the sector's revenue base, which consists of earned income, government support, and philanthropy. Together, charities, nonprofits, governments, and the private sector need to explore innovation within each of these revenue streams in order to build on the sector's achievement and sustain the benefits it provides to Canadian communities."

– Bruce MacDonald, President and CEO, Imagine Canada

a) Allow charities and a sub-set of NPOs with clear public benefit objectives to pursue certain related business activities on an income tax exempt basis, and to pursue other business activities subject to income tax.

In 2010, the Canadian Task Force on Social Finance recommended the adoption of a destination of profits test, according to which an NPO or charity could engage in any revenue generating activity on an income tax exempt basis provided that the proceeds are used to advance its public benefit objectives.[39] While this would have the advantage of simplicity, it might raise concerns about horizontal equity or mission drift. This report offers a pragmatic alternative that captures the spirit of this rule – the focus on public benefit.

Currently, charities – with the exception of private foundations – are permitted to operate related businesses, which are narrowly defined. It is recommended that the definition of a related business be expanded and applied equally to all charities and to a suitable sub-set of NPOs, with any business activity that falls outside of this definition being permissible within the structure of the charity or NPO, but subject to income tax. Fundamentally, this would allow charities and NPOs the flexibility to engage in any revenue generating activity (subject to other relevant laws) without suffering penalties. It should be noted that this recommendation in no way intends to deprive registered charities of tax exemptions that exist under the current related business provisions.

The changes proposed in this recommendation should be restricted to registered charities, including private foundations, and a sub-set of NPOs under paragraph 149(1)(l) that serve a clear public benefit. The widely accepted International Classification of Non-profit Organizations, which classifies NPOs according to 12 primary areas of activity, could be used as the basis for defining the sub-set of NPOs that would qualify as serving a clear public benefit.[40] An alternative would be to emulate the definition that has been used by the Ontario Nonprofit Network in certain agreements with the Government of Ontario, which includes an asset lock in addition to public benefit requirements.[41]

This recommendation has some commonality with the Unrelated Business Income Tax (UBIT) policy, which the Internal Revenue Service administers in the United States. An overview of select international models for regulating charitable business activity can be found in Annex C.

More specifically, it is recommended that the requirement for a related business to be linked to the organization's purpose be adjusted to capture a broader range of revenue generating activity, which would be permissible within the structure of the organization, and tax-exempt. Excluded from the tax exemption would be businesses that are: only complementary to the organization's programs and/or objectives insofar as they provide a source of revenue that is used to advance these programs and/or objectives; not based on the sale of donated items; and run using employees and/or physical assets that are separate from the charity or NPO. Such activity could still be pursued within the registered charity or NPO, but would be subject to the corporate rates of tax applicable to Canadian Controlled Private Corporations (CCPCs).

Under this definition, examples of activities that would be subject to applicable income tax include:

a) An organization established for the purpose of providing food at no cost to a low-income population running a commercial restaurant in a separate building, with separate employees, and using the profits of this restaurant to finance its food bank;

b) An organization established for the purpose of providing low-income housing owning and operating a hotel, and using the profits to finance the purchase of a separate property for low-income housing; and

c) An organization purchasing a franchise and operating the business to direct profits to its public benefit activities, with no social hiring or other direct public benefit objectives expressed within the franchise.

For illustrative purposes only, the following are examples of business activities that should be allowed on an income tax exempt basis, when pursued by registered charities or a subset of NPOs with public benefit objectives, or that may currently be allowed in certain cases but for which the CRA guidance is unclear. These are only a few of many possible examples:

a) Charging a fee to certain clients based on ability to pay, for example: an organization that sells healthy foods at market rates to those who can pay, and provides healthy foods at no or low cost to a low-income population; or an organization that runs a job training program targeting individuals who face labour market barriers and charges a fee to certain employers, based on their ability to pay;

b) Selling donated items, including in the context of a sustained business operation that uses separate staff, for example, an organization that runs a hardware store selling donated construction materials that are used, end-of-line or damaged, and uses the proceeds to advance its public benefit mission; and

c) Using physical, human, or other assets associated with the organization's programs and/or objectives to generate revenue, for example: a youth entrepreneurship training facility that rents unused space to paying clients; or an organization that runs a mixed-income building, a significant portion of which is used for low-income housing and the rest of which is rented at market rates.

In addition, a *de minimi*s test could specify that if revenue from any activity is less than a prescribed amount, the revenue would be exempt from income tax.

Without suggesting a specific maximum portion of charitable or NPO resources that could be allocated to business activities, it is recommended that this should be higher than under the current charity rules, which state that a related business, unless it is run substantially by volunteers, must be subordinate to the charity's purposes, receiving no more than "a minor portion of the charity's attention and resources." Different thresholds could apply for tax-exempt and taxable businesses within the organization. This change would recognize the importance of investing in the success of a business, to ensure a reliable source of revenue, while remaining focused primarily on public benefit objectives. The existing requirement for a related business to be "integrated into the charity's operations, rather than acting as a self-contained unit" is also overly restrictive.

In keeping with the current rules, any business activity that directly advances a charitable or public benefit purpose (for example, by employing individuals who face labour market barriers) should be permissible on a tax-exempt basis, for charities and NPOs. In particular, charitable activities that generate revenue should continue to be counted as charitable activities. These activities would not be subject to any restriction on the percentage of an organization's assets that could be utilized by them.

In addition, charities should continue to be permitted, where appropriate to protect assets from business risk, to run a business as a separate taxable subsidiary. Consideration could be given to adapting the rules to allow charities to fund subsidiaries more easily. Similar permission should apply to NPOs. To this end, it is recommended that enabling guidance pertaining to NPOs running for-profit subsidiaries be released.

Finally, it is recommended that charities and NPOs operating businesses be required to report on business activities. Reports could be made public on the CRA website. This would enhance current reporting requirements for charities, and extend reporting requirements to NPOs, supporting transparency and accountability. Caution should be exercised, however, to ensure that reporting requirements do not place an undue burden on charities or NPOs.

It should be noted that the introduction of a purpose-built corporate form for social enterprises – for example, allowing share capital to be raised, and requiring a community benefit purpose, caps on dividends, and an asset lock, as in British Columbia – would not address many of the challenges outlined in this part of the report. While a distinct legal structure would provide a useful addition to the range of structural options available to social enterprises, it does not supersede the need to enable social enterprise activity among charities and NPOs. Social entrepreneurs should have the flexibility to choose the structure that best suits their needs. Social enterprises that are not seeking to attract share capital, and that need an income tax exemption or qualified donee status (in the case of charities) to remain viable, will continue to require a charitable or NPO structure.

"The world is changing and Canadian charities, nonprofit and cooperative organizations providing public benefit in their communities need to adapt too. Updating the Income Tax Act and related regulations that constrain social enterprise activity in nonprofit organizations will allow them to further build community wealth and vibrant, thriving communities. Canada has one of the strongest public benefit sectors in the world. Let's keep it that way."

– *Cathy Taylor, Executive Director, Ontario Nonprofit Network*

b) Allow charities to provide a private benefit where it is necessary to achieve a broader public benefit.

Finally, guidance on the public benefit test for charities should be reexamined to ensure that a private benefit is permissible where it is necessary to achieve a broader public benefit. For example, charities should be allowed to support employer recruitment efforts when this would achieve better employment outcomes for disadvantaged populations.

Figure 2 Summary chart: Proposed business activity categories for charities and a subset of NPOs with public benefit objectives

TYPE OF BUSINESS ACTIVITY	INTERNAL TO THE ORGANIZATION / SEPARATE	TAXABLE / TAX-EXEMPT	PERCENT OF ASSETS THAT CAN BE USED TO RUN THE BUSINESS
1. Directly advances a charitable or public benefit purpose	Internal	Tax-exempt	No limit
2. Complementary to the organization's programs and/or objectives (beyond providing a source of revenue); based on the sale of donated items; or run using the charity/NPO's employees or physical assets	Internal	Tax-exempt	Limited, but higher than under current related business rules for charities; similar rules would apply to NPOs
3. Does not meet the criteria for #1 or #2, but revenue falls under a specified *de minimis* threshold	Internal	Tax-exempt	Limited, but higher than under current related business rules for charities; similar rules would apply to NPOs
4. Only complementary to the organization's programs and/or objectives insofar as it provides a source of revenue that is used to advance these programs and/or objectives; not based on the sale of donated items; and run using separate employees and physical assets from the charity or NPO	Internal	Taxable	More limited than for business-es in categories #2 and #3
5. For-profit subsidiary	Separate	Taxable	Limited, but current rules could be adapted to allow subsidiaries of charities to be funded more easily; similar rules should apply to NPOs and CRA guidance should explicitly permit NPO ownership of separate taxable businesses

5.2 Analysis of potential risks and costs

Horizontal equity

There is a risk that some for-profit business stakeholders may perceive more facilitative rules with respect to revenue generating activity by charities and NPOs as providing these entities with an unfair competitive advantage through tax exemptions and other tax assistance. The proposed requirement to pay income tax on certain revenue generating activities would help to address this concern.

It is important to note that expecting enterprising charities and NPOs to adopt taxable corporate forms would in many cases not be viable, particularly for smaller organizations. A social enterprise that directs all profits to a public benefit purpose, and invests less than its for-profit counterparts in, for example, new technology, employee training, or growing the business, would find it challenging to develop a self-sustaining business model. A case study on Eva's Phoenix Print Shop, in Annex B, illustrates these challenges.

Enterprising charities and NPOs often employ individuals who face labour market barriers, serve populations that would not otherwise be able to access or afford important services, rely on volunteer labour that is potentially untrained, focus on delivering their public benefit mandate rather than on maximizing profit, and have higher costs associated with this mandate. The tax exemptions provided to charities and NPOs help to level the playing field and allow more resources to flow to the public benefit purposes of these organizations.

Moral hazards

Another risk relates to mission drift – specifically, the risk that a charity or NPO could devote most of its time and resources to developing and running a business rather than to advancing its public benefit purpose. This would be addressed through limitations on the proportion of a charity's or NPO's assets that could be dedicated to the business.

Existing rules, for example related to self-dealing, would continue to protect against abuse of the ITA, as would the proposed public reporting requirements for business activity.

Business risk

The importance of enabling charities and NPOs to improve their sustainability and better deliver on their public benefit objectives via revenue generating activity – which is a core premise of this report – merits emphasis. While many businesses fail, this risk is outweighed by the benefits. An emerging class of donors, recognizing this, may be keen to have their donations support the development of business activities. The existing risk that charitable donations could be used to fund unsuccessful programs should also be noted.

In addition, social enterprise activity can be viewed as a new phase of fundraising. Donations are currently used to finance fundraising activities, such as gala events, which are expected to yield a net gain. Using donations to finance business development is therefore not a complete departure from conventional practices.

While the possibility of donations being used to finance a business that proves unsuccessful could raise concerns for some charitable donors (including past donors), this concern would be mitigated by the proposed limitations on the proportion of an organization's assets that could be used to fund certain types of business activities. In addition, donors would continue to have the option of providing directed donations, stipulating that their gift be used solely for charitable programs.

Costs

These recommendations would be unlikely to result in significant tax revenue losses. Many NPOs already operate under the assumption that they are allowed to intentionally generate profits. These profits are often directed into social programs in the same year, resulting in low net annual profit. In addition, it is unlikely that charities currently operating taxable subsidiaries would dismantle these corporations in order to bring the business in-house; even if they did, the tax differential would not be significant as these subsidiaries already benefit from income tax deductions based on donations to the parent charity.

It is the National Advisory Board's view that these proposals would generate a net positive benefit for Canada, given that enterprising charities and NPOs would face fewer restrictions in achieving financial sustainability and expanding effective social services.

5.3 Recommendation 2:
Unlock foundation capital for impact investing

To unlock foundation capital for impact investing, action at the federal and provincial levels is needed.

> "Looking ahead a few years, social finance should be a key part of how foundations in Canada have impact. We are ready to use more and more of our assets for public good, but in order to maximize this potential, we will need a more enabling legislative and policy environment."
>
> *– Ian Bird, President, Community Foundations of Canada*

a) Clarify that impact investments can be part of a balanced portfolio under current prudent investor rules.

Part of the answer to unlocking more foundation capital for impact investment lies in clarifying permissible investments under provincial trust law. Both low- and high-risk impact investments are currently permitted as part of a balanced portfolio. It could also be reinforced that prudent investor rules do not exclude consideration of other factors, such as social impact.

While a foundation would not wish to invest all of its assets in high-risk ventures – for example, unsecured investments in early stage social enterprises – a portion of a balanced investment portfolio could be allocated to higher risk impact investments. A range of low-risk impact investments is also available, allowing for the possibility of a foundation devoting 100 percent of its endowment to impact investments, while maintaining a balanced portfolio.

This recommendation falls under provincial jurisdiction.

b) Alter trust law to state that, in the case of a charity, a prudent investor <u>should</u> consider social impact.

Going a step further, it could be explicitly stated that, in the case of a charity, a prudent investor should consider social impact. This would encourage more charities (generally foundations) to consider impact investments.

This recommendation also falls under provincial jurisdiction.

c) Allow charities to make below market rate investments, where appropriate to advance their charitable objectives.

Traditionally, foundation activities have been understood to fall into the two distinct categories of charitable granting and financial investment. Impact investment crosses this divide, and for impact investments that may not be entirely justifiable as financial investments under existing trust law, a new category is needed. This could be achieved through changes to the ITA or related guidance, potentially supported by changes to provincial trust law.

It is recommended that charities be permitted to make investments with the aim of advancing their charitable purposes and for which below market rate returns are expected, regardless of whether the recipient is a charity, NPO, co-operative, for-profit, or hybrid entity. No part of these investments, or any associated opportunity costs, should be considered as gifts to non-qualified donees.

It is important to recognize that many impact investments are prudent by traditional financial standards; however, there are situations in which below market rate impact investments may be warranted. For example, tranched investing, with certain investors taking higher-risk positions that are not necessarily paired with commensurate returns, may be necessary to attract more risk-averse capital to worthwhile projects.

However, in the current context of a 3.5 percent disbursement quota, it is not recommended that a charity be permitted to count losses or opportunity costs resulting from this type of impact investment towards its annual disbursement quota, except insofar as the current rules permit this for investments in qualified donees. While such a measure could help to encourage foundation boards and investment committees to make this type of impact investment, the National Advisory Board's position is that impact investments should complement rather than replace existing charitable granting activity.

One option for implementing this recommendation would be to allow charities to provide financial assistance to any form of organization whose operations result in a direct, tangible public benefit, and not only to qualified donees, provided that charities exercise expenditure responsibility, ensuring that their assets are used to advance their charitable purposes.

This recommendation would likely be supported by the recommendation to allow charities to provide a private benefit (in this case, provided to the recipient of the investment) where it is necessary to achieve a broader public benefit (Recommendation 1b).

In the United States, foundations are allowed, and even encouraged, to make a range of below market rate investments in furtherance of their charitable objectives. Information on select international models for regulating foundation impact investments can be found in Annex C.

d) Allow charities to invest in limited partnerships.

Finally, the ITA should be amended to allow charities to invest in limited partnerships, by adding a reference to section 149.1 in section 253.1. This would clarify that charities would not, if they were holding an interest as a limited partner, be considered to be carrying on any business of the partnership, solely due to their acquisition and holding of that interest.[42]

"Foundations as charitable investors are eager to broaden the scope of their investments for social impact. The opportunity to provide more capital for social purposes through asset aggregating structures such as Limited Partnerships would certainly expand the market for impact investing and also permit endowed charities to fulfill their fiduciary commitments to prudent and diversified investment strategies. We strongly encourage the federal government to reconsider the current limitation on charities that prevents them from investing as passive investors and not business owners in a widely offered and accepted investment asset class of Limited Partnerships."
– Hilary Pearson, Philanthropic Foundations Canada

5.4 Analysis of potential risks and costs

Moral hazards

Existing rules restricting investment practices and governing the use of charitable resources would continue to safeguard against abuse of the ITA (for example, a foundation investing at below market rates in a business in which it has a private interest).

Investment risk

As prudent investors, trustees would continue to determine the proportion of a foundation's overall investment portfolio that could be dedicated to higher risk investments (whether impact investments, venture capital investments, or other investments), to ensure a balanced portfolio, support the advancement of the foundation's charitable purposes, and guard against the depletion of the foundation's endowment, as appropriate. It should be remembered that risk is not unique to impact investments.

5.5 Supporting recommendations

While not a focus of this report, consideration should also be given to fostering intergovernmental coordination on measures to accelerate social enterprise development and impact investment in the non-profit and charitable sector, potentially through an intergovernmental forum.[43]

It is vital for early NPO and charity leaders to communicate best practices, in order to contribute to a culture shift towards confidently deploying social entrepreneurship and impact investment tools where appropriate.

NPOs and charities have indicated other barriers to raising investment capital that stem, for example, from securities laws at the provincial level. These issues could be the subjects of future studies.

6. CONCLUSION

The recommendations advanced in Section 5 could have a catalytic impact on the Canadian impact investment market. They would create a more enabling environment for the development of investment-ready social enterprises in the charitable and non-profit sector, and unlock additional foundation capital for impact investment.

Most importantly, these changes would contribute to the development of a more sustainable, efficient, and effective non-profit and charitable sector, with an enhanced ability to improve social outcomes for Canadian communities.

Annex A: Organizational structures for social enterprises in Canada

Social enterprises exist across a spectrum, including charities, non-profit organizations, co-operatives, and for-profit corporations. A hybrid corporate form for social enterprises has also been established in British Columbia – the Community Contribution Company (C3). Nova Scotia has passed Community Interest Company (CIC) legislation; however, the regulations are still in development. Ontario has launched a consultation process on a potential hybrid corporate form. This diversity is important, as it allows social entrepreneurs to choose from a wide menu of legal structures, to identify the one that best suits their needs and objectives.

Figure 3 describes the structural options currently available to social enterprises in Canada.

Figure 3

For-Profit Business	• Not specifically designed for a social purpose • Can receive certification as a B Corporation • Incorporated under the *Canadian Business Corporations Act* or provincial equivalent; can also be structured as a sole proprietorship, a partnership, or a business trust • Flexibility in activities, capital raising, managing assets, and revenue generation • No income tax exemption; cannot receive funds from charities, except through market rate investments • Responsibility to shareholders, when shares have been issued to raise capital
Registered Charity	• Non-share capital corporations with legally enforced social purpose (within the definition of charitable purpose) • Restrictions on business activities; can operate a related business (substantially run by volunteers or linked and subordinate to the charity's purpose); assets are locked • Generally derive their revenue from a combination of earned income, government grants, and donations; as qualified donees, can receive grants from other charities; can be eligible for debt financing; generally cannot issue shares • Exempt from paying income tax; can issue donation receipts for donor tax benefits
Non-profit Organization	• Non-share capital corporations with legally enforced non-profit purpose (broader range of allowable activities / purposes than for charities) • Generally derive their revenue from a combination of earned income and government grants; not eligible for charitable grants; can be eligible for debt financing; generally cannot issue shares • Subject to increasing scrutiny regarding earned income activity; according to certain CRA guidance, not allowed to have the intention of generating a profit • Generally exempt from paying income tax; cannot issue donation receipts
Co-operative	• Owned and democratically controlled by its members; generally designed to benefit members • One member, one vote • Must reinvest surplus to benefit members or broader community • Ability to raise outside capital through shares and loans • Limits on interest and dividends • No preferential tax treatment
Community Contribution Company (C3)	• Introduced in British Columbia (BC); option became available in July 2013 • Modeled on the United Kingdom (UK) CIC; informed by the BC Social Innovation Council • Established through amendments to the *Business Corporations Act* and C3 regulations • Legally enforced social purpose; majority of profits must be used for community purposes or transferred to a qualified entity • Cap on dividends payable to investors of 40 percent of annual profits; asset lock upon dissolution (at least 60 percent of assets must be directed to qualified entities) • Requirement for annual reporting on community contributions; no official verification of reports; no regulator • A taxable corporation • We understand that there are currently 14 C3s registered in BC (as of April 2014).
Community Interest Company (CIC)	• Introduced in Nova Scotia; modeled on the UK CIC; similar to the C3 • *Community Interest Companies Act* passed in December 2012; regulations are still in development (option not yet available) • Registrar of Community Interest Companies to oversee formation and conduct of CICs

Annex B: Case studies

CASE STUDY – RELATED BUSINESS: HABITAT FOR HUMANITY'S RESTORE

Habitat for Humanity Canada, a charity, acts as an umbrella organization for about 60 affiliates across the country. Its mandate is to provide affordable housing for low-income families. In its early years, Habitat struggled to expand, due partly to donations being directed to particular housing projects, leaving limited discretionary funds to build organizational capacity.

Habitat launched ReStore in 1991 to overcome this hurdle. While there is some variation among affiliates, in general, ReStores sell recycled, end-of-line, or damaged building materials, which are donated. Net revenues are used to fund Habitat's charitable activities. Some ReStores also provide skills training and employment for disadvantaged groups. They are operated by a combination of volunteers (generally 75 percent) and paid employees (usually one dedicated full-time manager, and a paid truck driver for pickup of donated materials).

In the last several years, we understand that the CRA has been assessing whether the ReStore model constitutes a fundraising activity or a business activity. Most recently, the CRA suggested that ReStores were not meeting the requirements of a fundraising activity or of a related business.

To qualify as a related business, the CRA indicated that ReStores would need to be: 1) 90 percent volunteer-run (based on a head-count of paid employees and volunteers working at least 40 hours a year) and generate no more than 50 percent of Habitat affiliates' revenue and operate using no more than 50 percent of their resources; or 2) sell only excess material from its build sites and not accept donations with the main purpose of sale at ReStores (rather than for the purpose of building affordable housing).

Under this interpretation, few, if any, ReStores would – or could – meet the latter requirement, while many would struggle to recruit a sufficient number of volunteers to meet the 90 percent rule. Even if they could be met, these requirements would challenge the sustainability, scalability, and efficiency of the model.

Other possible remedies were considered: 1) create a separate, taxable corporation (which would pay tax on remaining taxable income after donating up to 75 percent of its net income to the Habitat affiliate); 2) create a separate non-profit organization with its own board of directors; or 3) seek to operate ReStore as a charitable program.

The viability of these options would require further analysis. The ReStore model relies on donated building materials, for which a charitable donation receipt is issued. Operating ReStore as a separate for-profit corporation or non-profit organization would require Habitat affiliates to receive and provide receipts for donated goods and to sell these through the separate for-profit or non-profit entity, on the basis of a consignment or similar arrangement, with profits flowing back to the affiliate.

The for-profit option could elicit loss of credibility among donors and volunteers, and potential uncertainty about the maintenance of ReStore's social purpose, and relationship to the affiliate, over time. In addition, operating as a for-profit corporation would mean losing the benefits of charitable status – income tax exemption, ability to issue charitable donation receipts, and qualified donee status – which could make it challenging to sustain a business that is focused on supporting a charitable mission, and therefore has fewer funds available for business development.

For the non-profit option, it is not clear that ReStore would meet the associated prohibition (expressed in certain CRA guidance) on intending to generate a profit.

To become a separate registered charity, a ReStore would likely need to adjust its model, in line with a particular charitable purpose (e.g., protection of the environment, through a focus on recycling construction materials; or relief of poverty, through a focus on employing or training disadvantaged individuals).

Habitat has invested thousands of dollars in legal fees and significant staff and board time to ensure a robust understanding of CRA guidance. Ultimately, the CRA indicated that Habitat could continue to operate as it has been, subject to further instruction.

While Habitat's ReStore continues to operate, and is widely regarded as a best practice, the CRA has suggested that it is not in compliance with the ITA. This may limit Habitat's growth plans, and could inhibit other charities from adopting similarly effective models.

CASE STUDY – PUBLIC BENEFIT RULES: SOCIAL CAPITAL PARTNERS

Social Capital Partners (SCP) is a non-profit organization that applies market-based solutions to improve outcomes for people who face barriers to employment, focusing on youth, new Canadians, persons with disabilities, Aboriginal peoples, and single parents. It was founded in 2001 by Bill Young, a Canadian business leader and philanthropist.

Through community employment loans to small businesses and partnerships with employers, SCP has facilitated thousands of employment opportunities for people who face labour market barriers.

An initial application for charitable status was rejected, leaving SCP without access to charitable grants or the ability to provide receipts for donations. SCP has, however, received funding from charitable organizations, which have used SCP's innovative approaches to advance their own charitable objectives, related to the alleviation of poverty. Maintaining a focus on the charitable objectives of these organizations can, however, challenge SCP's ability to operate in a way that maximizes efficiency and effectiveness.

Based on its experience working with employers, SCP is currently testing a program based on the principle that training for individuals who face employment barriers should shift from a supply (job seekers) focus, towards a demand (employer) focus, to ensure alignment with labour market needs. Making it easier for employers to hire individuals who face barriers to employment ultimately generates more robust outcomes for the individuals involved (i.e., more stable and meaningful employment) and for society as a whole (i.e., reduced unemployment).

We understand that the CRA has indicated that the public benefit rule may exclude SCP's job training program from being considered charitable, and therefore from receiving funding from a registered charity. This is because it could be viewed as providing a private benefit to employers that is not incidental to achieving the charitable objective of poverty alleviation – even if the program demonstrates significantly improved outcomes aligned with this objective.

CASE STUDY – EXPENSE OF RUNNING A SOCIAL ENTERPRISE: EVA'S PHOENIX PRINT SHOP

Eva's Phoenix Print Shop is a socially and environmentally responsible commercial printing company that employs and trains homeless and at-risk youth. It operates within a charitable organization, and combines practical job training with a broader array of services, including transitional housing, counseling, job placement assistance, a scholarship fund, and mentorship and follow-up support, with a focus on enabling youth to become self-sufficient over the long-term. Over 70 percent of graduates from Eva's Phoenix Print Shop have entered full-time work or returned to school.

It has established cooperative arrangements with private sector stakeholders. For example, Xerox has allowed Eva's Phoenix to retain old equipment as part of an agreement to lease new equipment. In addition, a number of for-profit print shops have agreed to consider hiring youth trained at Eva's Phoenix. Eva's Phoenix seeks to target its services to companies with corporate social responsibility policies.

Training and supporting youth constitutes an added expense line, reducing the funds available for business development. Charitable status is important to Eva's Phoenix Print Shop. An income tax exemption, access to charitable grants and donations, and the trusted brand identity associated with charitable status help to offset the challenges of running a business in which profits are reinvested in youth programs.

Annex C: International and domestic models

UNITED STATES (US): UNRELATED BUSINESS INCOME TAX (UBIT)

In general, organizations that benefit from an income tax exemption in the US are not taxed on business activities that are "substantially related to the charitable, educational, or other purpose that is the basis for the organization's exemption."[44] Business activities that do not meet this test, and that are regularly conducted, are subject to income tax at corporate rates.[45]

A business is regularly conducted if it is pursued frequently and continuously, and in a similar manner to comparable businesses run by for-profit organizations.

To be substantially related to the organization's exempt purpose, a business must "contribute importantly to accomplishing that purpose (other than through the production of funds)."[46] To meet this test, the scale of the business activity must not be greater than necessary to carry out the exempt purpose. A link to the exempt purpose on its own is insufficient. For example, selling products that result from the pursuit of the exempt purpose would only qualify as a related business if the products were sold more or less in the form in which they were created, or with further processing only to the extent needed to dispose of them. Dual use of assets or facilities would also not qualify as a related business, unless they were used in a way that contributed importantly to advancing the exempt purpose.[47]

A number of exceptions exist, including for: certain income related to investments, royalties, rentals, research activities, gains or losses from the disposition of property; any business substantially carried out by volunteers; businesses carried on primarily for the benefit of the organizations' members, students, patients, officers, or employees (such as a school cafeteria); any business based substantially on the sale of donated merchandise; and certain bingo games; among other activities.[48]

Examples of related and unrelated businesses and exempt activities can be found in the Internal Revenue Service (IRS) publication *Tax on Unrelated Business Income of Exempt Organizations.*[49]

This model arguably addresses concerns about unfair competition, but may be associated with certain challenges, related, for example, to the accounting complexity of allocating expenditures to taxable and tax-exempt operations.[50]

US: PROGRAM RELATED INVESTMENT (PRI)

In the US, PRIs are defined as investments: that are made primarily to accomplish one or more of the foundation's charitable purposes; for which the production of income or appreciation of property is not a significant purpose (an indicator of which is whether profit-minded investors would be likely to make the investment on the same terms); and which do not have a purpose of political lobbying. The potential for a high rate of return does not necessarily disqualify an investment from being a PRI.

PRIs are exempt from treatment as jeopardizing investments – investments that could threaten a foundation's ability to pursue its charitable activities, for which foundations may be fined. [51]

PRIs are excluded from the assets that must be counted in determining how much a foundation is required to disburse in a given tax year. Like grants, they can also be counted towards a foundation's five percent disbursement requirement in the year the PRI is made. PRI principal repayments must be recycled as new PRIs or grants in the year in which they are received, over and above the five percent requirement. Any interest, capital appreciation, or dividends are considered as income.[52]

PRI recipients can include non-profit or for-profit organizations, or individuals, provided that they are instruments for advancing a charitable purpose – investees do not need to be charities themselves. The foundation must exercise expenditure responsibility, which could mean obtaining written agreement from the PRI recipient that the investment capital will be used only to accomplish a specified charitable purpose. PRIs can take the form of loans, equity investments, or credit enhancements.[53] The IRS recently issued proposed regulations outlining a series of new PRI examples, to further clarify cases in which PRIs are permissible. Final action will be taken on these proposed regulations by the end of 2014.[54]

Use of PRIs has been increasing in the US; however, the practice remains restricted to less than one percent of US foundations, and is more common among large foundations.[55] Foundations that use PRIs as a key part of their charitable strategies include, for example, the Rockefeller Foundation, Ford Foundation, Bill and Melinda Gates Foundation, F. B. Heron Foundation, and Omidyar Network.[56]

While most foundations count PRIs towards their annual five percent grant disbursement requirement, some make PRIs outside of this requirement.[57]

UNITED KINGDOM (UK): PRIMARY PURPOSE AND NON-CHARITABLE TRADING

In the UK, primary purpose trading (which occurs in the course of carrying out the charity's purpose) and trading carried out mainly by beneficiaries of the charity are both exempt from tax.

In the case of non-charitable trading, which is used to raise funds to advance the charitable purpose, profits are subject to tax unless the trading activity generates income that is less than £5,000 or accounts for no more than 25 percent of overall income up to a limit of £50,000 (small trading exemption).[58] This form of trading is permissible only if no significant risk to charitable assets is involved.[59]

Charities are also permitted to use separate, taxable trading subsidiaries, which can donate their profits to the parent charity through Gift Aid contributions, reducing or eliminating the profits that are subject to tax. This structure can be used to protect the charity's assets from business-related risk.[60]

Under the Gift Aid program, charities can reclaim the equivalent of the basic rate of income tax (20 percent) on a donation from an individual, such that a £10 donation becomes worth £12.50. Donors can only claim a tax credit for a donation if they pay a higher tax rate – in which case, they can claim the difference between the basic and higher tax rates on a donation.[61]

UNITED KINGDOM (UK): PROGRAM-RELATED AND MIXED MOTIVE INVESTMENTS

In the UK, a program-related investment (PRI) is an investment that directly furthers the charity's stated aims. A PRI has the potential to achieve a financial return, but this is not its primary objective. Trustees making PRIs are not subject to the legal rules governing financial investments, because PRIs are not investments in a strict legal sense. Any private benefit resulting from a PRI must be "necessary, reasonable and in the interests of the charity."[62]

Any losses resulting from PRIs are counted as charitable expenditures. Charities in the UK are not required to meet an annual quota for charitable expenditures;[63] however, they are required to spend the income they receive within a reasonable period of time. Trustees should therefore be able to justify any retained income as reserves.[64]

A mixed motive investment (MMI) is intended to advance the charity's aims and achieve a financial return. Generally, an MMI could not be entirely justified either as a PRI or as a financial investment, but includes elements of both.[65]

Guidance and case studies clarifying the ability of foundations to make various kinds of investments to further their charitable aims, including through subordinated investments in co-mingled funds, has been released in the last few years.[66]

In addition, the UK Law Commission has launched a consultation on social investment by charities, which proposes a new statutory power to make social investments that would clarify and supplement existing provisions.[67]

AUSTRALIA AND NEW ZEALAND: DESTINATION OF PROFITS TEST

In Australia and New Zealand, charities are allowed to generate revenue through businesses activities, on an income tax exempt basis, provided that profits are used to advance the charitable purpose of the organization and are not for private financial benefit.

In a 2008 case, Commissioner of Taxation of the Commonwealth of Australia v Word Investments Ltd, the High Court of Australia determined that, where the aim of making a profit is only in aid of an organization's charitable purposes, it should be considered as incidental or ancillary to these purposes and should not be regarded as an end in itself. It stated that "[t]o point to the goal of profit and isolate it as the relevant purpose is to create a false dichotomy between characterisation of an institution as commercial and characterisation of it as charitable." [68]

This system has been supported by Australia's 2010 Future Tax System report, Productivity Commission studies, and 1995 Industry Commission Charities report. These reports concluded that income tax exemptions for non-profit organizations do not result in an unfair competitive advantage, given that they do not affect output or pricing decisions, or the aim to maximize profit. In general, the difference between for-profit and non-profit organizations lies in whether profit is directed to private gain or community benefit. While income tax may cause for-profit organizations to seek to use profits in ways that minimize their tax exposure, this impact was considered to be minimal. These studies did conclude, however, that exemptions from input taxes, such as the fringe benefits tax (FBT), created market distortions given, for example, the contingent ability to pay market wages at a lower cost.[69] The Future Tax System report recommended that NPOs "should be permitted to apply their income tax concessions to their commercial activities."[70] This review was conducted by a panel chaired by Dr. Kenneth Ross Henry, who was the Secretary of the Department of the Treasury at the time.

We understand that consideration was given to adopting an unrelated business income tax in Australia, but the line between related and unrelated business, and the range of exceptions, was ultimately determined to be too difficult to define.[71]

Sections 5(3) and 5(4) of the New Zealand *Charities Act* specify that a non-charitable purpose is permissible provided that it is "ancillary, secondary, subordinate, or incidental to a charitable purpose… and not an independent purpose."[72] According to Charities Services' guidance, this means that "a business may be registered as a charity if all its profits are directed to its charitable purposes" provided that other registration requirements are met.[73]

In both countries, decisions on business activities, including the amount of a charity's assets that can be used to run a business, rest with the charity's board, which is expected to act prudently.[74]

ONTARIO: *NOT-FOR-PROFIT CORPORATIONS ACT*

The Ontario *Not-for-Profit Corporations Act*, which has not yet passed into law, supports the concept of a destination of profits test.

In announcing Bill 65, the *Not-for-Profit Corporations Act*, in 2010, the Ontario government indicated that one of the highlights of the bill would be "[a]llowing not-for-profit corporations to engage in commercial activities where the revenues are reinvested in the corporation's not-for-profit purposes."[75]

The text of the Act indicates that if an organization has purposes of a commercial nature, then the articles of incorporation must "state that the commercial purpose is intended only to advance or support one or more of the non-profit purposes of the corporation." Regardless, this Act would not override the *Income Tax Act*.[76]

PART TWO

September 2014

Catalyzing impact investing: the opportunity for governments

Mobilizing Private Capital for Public Good: Priorities for Canada

Canada's National Advisory Board to the Social Impact Investment Taskforce

MaRS | CENTRE FOR IMPACT INVESTING

KPMG

Catalyzing impact investing: the opportunity for governments

Part 2 of this report was informed by Canada's National Advisory Board to the Social Impact Investment Taskforce, launched by the G8, and benefited from the insights of key informants.

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CATALYZING IMPACT INVESTING: THE OPPORTUNITY FOR GOVERNMENTS

1. INTRODUCTION

The intersection of social purpose and financial return is well established in Canada through the vast network of member-owned financial co-operatives including Vancity, Assiniboine Credit Union, and Desjardins. These credit unions and *caisses populaires* are values-driven, holding social and economic objectives, which are reflected in the innovative financial products and investment opportunities offered based on community and member needs.

Recently the term "impact investing" has emerged, as an increasing number of investors, financiers and ventures are taking note and entering into transactions that are based on similar principles. Impact investing differs from conventional investing as impact investors expect a financial return from their investment as well as a defined positive social impact, demonstrated through measureable social outcomes.

Further advancing the field are innovative market-based approaches that are emerging from the social entrepreneurship movement, effectively addressing key social issues and transforming lives. Social enterprises require funding beyond what can be fulfilled through traditional philanthropy or government funding. As the number of social enterprises and effective solutions are increasing, so too is the need to attract additional resources in the form of private capital, to fund the innovations being delivered. The impact investing market in Canada is still nascent, and government action is required to accelerate its growth.

The goal in this part of Canada's National Advisory Board report is to explore how the federal government, in particular, can help catalyze an increased flow of private capital directed towards impact investing, and strengthen the impact investing ecosystem in Canada.

This part of the report examines global examples of government measures that have been implemented to stimulate investment of private capital in impact investing and other priority areas, to identify success stories and lessons learned. Canadian examples of catalytic capital outside the scope of impact investing have been examined, particularly in the venture capital asset class. The types of government measures considered include credit enhancements, capital matching, guarantees, tax incentives, and outcomes-based finance.

The recommendations reflect the deep experience of Canada's National Advisory Board to the Social Impact Investment Taskforce established by the G8, as, for example, impact investors, impact investment fund managers, financial and not-for-profit sector leaders, and academics. Interviews have also been conducted with a select group of leaders in venture capital, wealth management, banking, and other areas of traditional finance to assess investor perceptions of government interventions designed to lower barriers to entering the impact investing market.

KEY RECOMMENDATIONS:

3. Establish an impact investing matching program, paired with appropriate incentives.
4. Establish an outcomes payment fund.

SUPPORTING RECOMMENDATIONS:

- Provide support for investment and contract readiness, to develop the pipeline of investment opportunities.
- Embed these initiatives in a broader strategy for building Canada's impact investment market, coordinating with all levels of government.
- Engage investors in the design of these initiatives.

2. SCOPE AND LIMITATIONS

The scope of this part of the report is focused on assessing the merits of government interventions designed to lower barriers to impact investing; and investors' perceptions of these interventions and how they may influence investment decisions. The intent is to stimulate and inform discussion regarding potential initiatives to catalyze increased placement of private capital in impact investments. Decisions regarding new public policy or the design of initiatives would require further assessment.

Canada's National Advisory Board has discussed the need to view impact investment as an opportunity to attract additional private capital to help solve social policy challenges, rather than as a replacement for government or philanthropic funding.

Initiatives to develop and strengthen the broader impact investing ecosystem are required. Government-led market building measures including to increase the capacity of social ventures or to address broader regulatory barriers to investment pipeline development are important, however fall outside of the scope of this part of the report.

3. SNAPSHOT OF IMPACT INVESTING IN CANADA

Impact investing covers a broad range of opportunities including investment in non-profit, public or private for-profit entities, or new forms of hybrid corporations such as Community Contribution Companies in British Columbia. Investment may be in the organization itself, or directed to a program designed to deliver a specific social outcome, such as supporting women and children at risk. Investment may be in early stage or mature organizations in the form of debt, equity, or innovative types of financing arrangements such as Social Impact Bonds (SIBs).

Examples of impact investing and related activities in Canada:

• **Social Capital Partners' Community Employment Loan program** provides access to low interest loans for small business owners, entrepreneurs, and franchisees based on their commitment to fill entry-level positions by hiring individuals who face employment barriers, including youth, new Canadians, and people with disabilities, through community employment service providers. The interest rate on the loan decreases for every employee hired from a partnering service provider.

• **The Community Forward Fund Assistance Corporation (CFFAC)** is a Canadian non-profit organization (NPO) that makes loans to, or arranges financing for, NPOs and charities. The Fund addresses a gap in access to patient working capital and provides bridge loans for the sector for small- and medium-sized organizations. Loan interest rates are dependent on the type of loan or guarantee, plus other fees. In addition to offering loans, CFFAC provides financial review and coaching services, and assessment tools to help build financial skills and capacity in the non-profit and charitable sector.

• **Capital régional et coopératif Desjardins** is a publicly-traded company created on the initiative of the Mouvement des caisses Desjardins. Managed by Desjardins Venture Capital, the development capital fund manager for the Mouvement des caisses Desjardins, Capital régional et coopératif Desjardins is rapidly becoming a major player on the Quebec development capital scene. One of its priorities is to meet the capital needs of co-operatives and to invest in the resource regions of Quebec. Geared to retail investors, shares may be purchased by any resident of Quebec and are eligible for a Quebec tax credit of 50 percent of the purchase amount.

• **Renewal Funds** provides an opportunity for investors to participate in the development of businesses at the forefront of social and environmental innovation. It invests in early stage growth companies with between $1 and $20 million in annual revenue. It is one of the largest investors in the organic and natural food and green products sectors in North America. Portfolio companies include Seventh Generation, a pioneer in developing household and sustainable cleaning products; and Kitchener, Ontario-based Miovision, which develops products and services that minimize traffic congestion, reduce environmental impacts of idling and inefficient transportation flow, and improve overall road safety.

• The **RBC Generator Fund** is a $10 million pool of capital for investing in for-profit businesses that not only generate a financial return, but also demonstrate community and social impact. In addition to being able to deliver market, or near-market returns, businesses must deliver benefits in the areas of energy, water, youth employment, or employment for disadvantaged groups, and be able to report on their impact to be considered for investment. Its portfolio includes a $250,000 equity investment in Nudge Rewards, a software provider that focuses on enabling and rewarding positive environmental, wellness, and community behaviours through its mobile platform.

• Community Bonds issued by the **Centre for Social Innovation (CSI)** were used to fund its expansion through the purchase and renovation of a 36,000 square foot building. As a further bonus, these bonds were eligible for inclusion in the bondholders' Registered Retirement Savings Plan accounts, enabling investors to take advantage of preferential tax treatment. A loan guarantee from the City of Toronto allowed CSI to secure a mortgage from Alterna Credit union, at an affordable interest rate. The sale of Community Bonds raised $2 million to cover the remaining funding gap.

• **Resilient Capital** is the result of a partnership between Vancity and the Vancouver Foundation to provide capital to eligible for-profit and non-profit social enterprises. Investors make Resilient Capital term deposits with Vancity held for a period of five to seven years that are 100 percent insured and earn a fixed rate of interest with return of principal on maturity. The founding partners created a first-loss reserve in support of the investments made; any additional risks are borne by Vancity.

As impact investing opportunities vary, so do the types of investors they may attract. Institutional investors, including banks, insurance companies, and pension funds; venture capital, private equity, and retail investors; and family offices, all have the potential to participate. A number of foundations, credit unions, and high net worth individuals are already leading the way.

4. THE OPPORTUNITY TO STIMULATE THE INVESTMENT OF PRIVATE CAPITAL

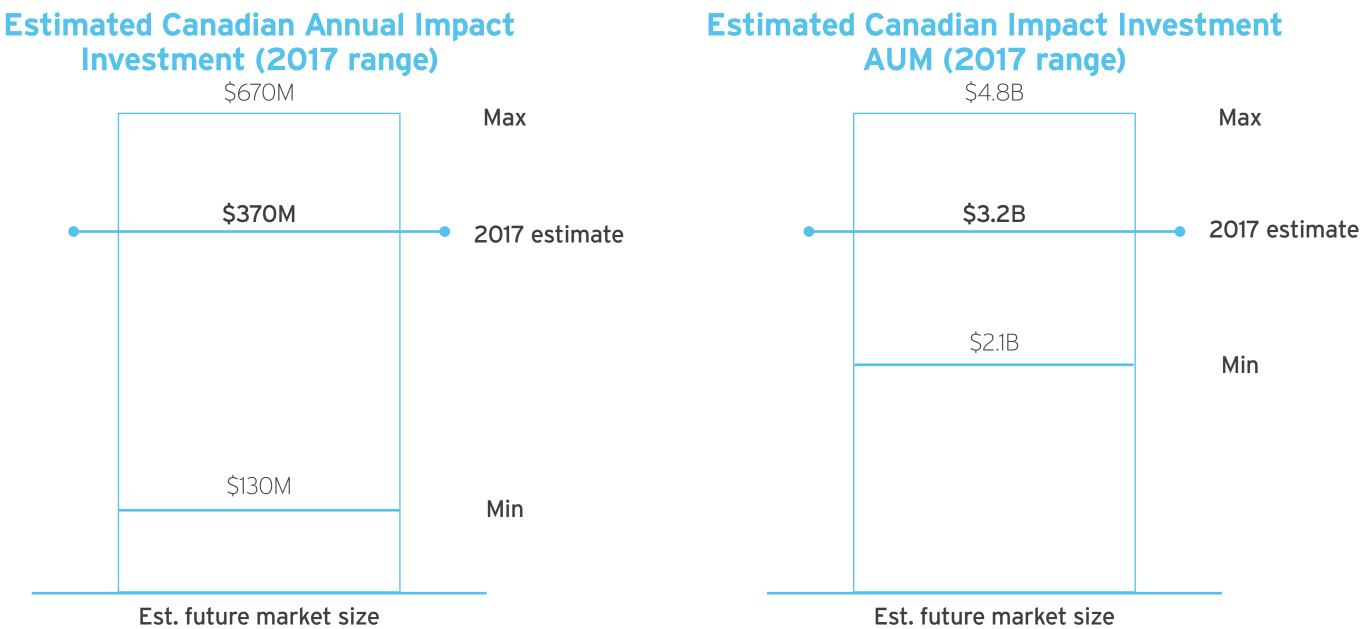
Impact investing is an innovative financing opportunity that enables market-based approaches to social challenges. The examples of impact investments noted in Section 3 illustrate the increasing demand for capital and the breadth of impact investing opportunities. Organizations have indicated that access to capital is a significant barrier to their ability to sustainably achieve social objectives.[77]

The amount of private capital directed towards impact investing is growing – the fourth annual global impact investor survey conducted by The Global Impact Investing Network (GIIN) and J.P. Morgan in 2013 gathered data from 125 impact investors, including pension funds, insurance companies, and high net worth individuals. These investors represent US$10.6 billion committed to impact investment with the intent to increase investment by 19 percent in 2014.[78] Existing activity in Canada has been estimated at $2.2 billion, based on the value of impact assets under management at foundations, community finance organizations, and credit unions. However, this estimate excludes assets invested by pension funds, high net worth individuals, and other institutional investors.[79] The 2010 report issued by the Canadian Task Force on Social Finance suggested that impact investment in Canada could potentially reach $30 billion, or one percent of assets under management.[80]

Figure 4: Potential for market growth in the near-term[81]

It is challenging to arrive at a reliable estimate of the current and potential size of the Canadian impact investment market, given a lack of transaction and portfolio data, and lack of definitional clarity. However, a comparison with the more advanced markets of the United States (US) and United Kingdom (UK) suggests significant growth potential. It is likely that this potential will only be realized with the initial support of government incentives.

This figure shows the potential 2017 Canadian impact investment market size, extrapolating from 2012 impact investment market size estimates for the US and UK as a share of gross domestic product (GDP) and capital markets, assuming US and UK market development is roughly five years ahead of Canadian market development.



The current size of Canada's impact investment market is estimated to be about $2.2 billion (MaRS State of the Nation Report 2013 – supply-side estimate)

Methodology: Potential for market growth in the near-term

Implied Potential Annual Canadian Impact Investment Market Size

Reference Country	USA ($CND B)	UK ($CDN B)
GDP	$16,245	$2,472
Capital Markets	$50,160	$9,091
Annual Impact Investment	$5.6	$0.32
Canadian GDP	$1,821	$1,821
Canadian Capital Markets	$3,462	$3,462
Implied Potential Canadian Annual Impact Investment via GDP	**$0.67**	**$0.25**
Implied Potential Canadian Annual Impact Investment via Capital Markets	**$0.41**	**$0.13**
Average	**$0.37**	

Implied Potential Canadian Impact Investment AUM Market Size

Reference Country	USA ($CND B)	UK ($CDN B)
GDP	$16,245	$2,472
Capital Markets	$50,160	$9,091
Impact Investment AUM	$28.2	$6.07
Canadian GDP	$1,821	$1,821
Canadian Capital Markets	$3,462	$3,462
Implied Potential Canadian Impact Investment AUM via GDP	**$3.36**	**$4.76**
Implied Potential Canadian Impact Investment AUM via Capital Markets	**$2.07**	**$2.46**
Average	**$3.16**	

Key steps in developing potential market size estimates:

- JP Morgan, Global Impact Investing Network, and Big Society Capital estimates used for US and UK impact investing AUM and annual market size
- Calculated impact investing share of US and UK capital markets and GDP
- Inferred possible impact investment share of Canadian capital markets and GDP
- Backed out potential Canadian impact investing AUM/annual investments from inferred GDP and capital markets share
- 2012 figures used due to data availability and for consistency

Caveats: These figures represent estimates of the potential size of the Canadian impact investment market based on comparisons with the US and UK markets, which are considered to be more mature. They are rough order of magnitude estimates, and a broad range is provided given that:

- Methodologies for classifying impact investments vary by source; thus, initial inputs are not based on consistent calculations.
- The size of capital markets and GDP are imperfect points of comparison for anchoring impact investment market estimates.

Research for this part of the report included interviews with experienced impact investors, venture capitalists, and conventional retail and institutional investors. As an emerging investment opportunity area, awareness and understanding of impact investing varied, with many identifying impact investing with financing charities and NPOs, over investment in for-profit entities with a social purpose.

Several key themes emerged from our discussions with potential and active impact investors. All investors considered the ability to generate financial returns as important, however there were varying expectations on financial return. Conventional investors were seeking market or risk-adjusted returns, and generally held the perception that impact investments were higher risk and that returns would not be aligned, thus compromising fiduciary duty.

Investors were also concerned about the financial viability of the investee. The ability to generate the desired social impact is a key driver for impact investment, but it does not compensate for weak governance or financial management, or unsustainable business models. The receiving organization needs to be well managed and pass other normal due diligence tests. The limited track record of impact investment opportunities has deterred some investors.

Government-led catalytic measures provide the opportunity to bridge the divide between the capital needed by social entrepreneurs, and potential impact investors. Governments can take steps to make it easier for investors to enter the market, enabling scale and lowering the perceived risk of impact investment opportunities, to help build a track record of successful investments and prove the viability of the market.

5. GOVERNMENT INTEREST IN IMPACT INVESTING IN CANADA

Governments in Canada and around the world are demonstrating active interest in impact investing and its role in directing capital towards investments with the added intent of delivering a social benefit, as evidenced by government initiatives focused on supporting social innovation, building the impact investing ecosystem, and catalyzing investment in social enterprises, in addition to the global popularity of SIBs. Increasingly, social challenges are being viewed as economic issues, and the focus is shifting towards results-oriented approaches.

One of the most visible examples of a government-enabled impact investment, SIBs have been issued in a number of countries including the UK, US, the Netherlands, Australia, and most recently, Canada.

The federal government and several provincial governments have undertaken initiatives that lay the framework for impact investing in Canada, for example:

- Over several decades, the Government of Quebec has been leveraging private investment for specific social, cultural, and environmental objectives through a variety of policies and programs including tax credits, first loss capital, and direct investment. For example, it helped catalyze investment in social economy enterprises through matching dollars from the corporate sector, leading to the creation of RISQ, a $10 million fund created in 1997 that has since made over 700 investments in NPOs, charities and co-operatives. The Government also made an investment of $10 million in 2007 in the Chantier de l'économie sociale Trust, a $52.8 million patient capital fund that has authorized over $37 million in investments for 128 social enterprises (as of December 31, 2013).
- The Government of Saskatchewan partnered with private investors and a non-profit service provider to launch Canada's first SIB in May 2014, designed to achieve the social outcome of keeping children out of foster care. The SIB is funding a program that provides affordable housing and support to single mothers with children under the age of eight who are at risk of requiring Child and Family Services, enabling them to complete their education, secure employment, or participate in pre-employment activities. The ultimate goal is to help these families to transition back into the community. The SIB raised $1 million in investment capital for a 5-year term, complementing funding from other levels of government and private donors. An independent assessor will measure outcomes at the end of years two, four, and five.
- Employment and Social Development Canada launched a literacy and essential skills pilot, surfacing new and effective ways of generating employer and private investments to help unemployed and underemployed Canadians to develop literacy and skills to better connect to available jobs. The pilot is inspired by global SIB precedents. Employers and investors will be reimbursed as they meet the objectives that were established together.
- The Government of Ontario provided startup funds to help launch and scale the SVX, an impact-first platform connecting impact ventures, funds, and investors in order to catalyze new debt and equity instrument capital for local ventures that have demonstrable social and/or environmental impact, including NPOs, charities, co-operatives and for-profit corporations. More recently, the Government of Ontario launched a call for SIB ideas, seeking innovative prevention-oriented solutions that address one or more high-priority social policy challenges facing Ontario families including housing, youth at risk, and improving employment opportunities for persons facing barriers.

- The Governments of British Columbia and Nova Scotia have both passed legislation to enable creation of a hybrid type of company – one that is for-profit with a socially beneficial purpose. This type of company, known as Community Contribution Companies and Community Interest Companies respectively, provides broader options for revenue generation and to attract investment, however is subject to certain requirements including restrictions on the distribution of dividends to retain profits within the company or to direct profits towards social benefit.
- The Government of Alberta is launching a $1 billion social innovation endowment fund, which will support the development of new approaches to solving social challenges, including through new funding models and partnerships. Finance Minister Doug Horner has indicated that the endowment "will be a catalyst for innovation for complex social issues."[82]

6. THE ROLE OF THE GOVERNMENT AS A CATALYST

Two basic scenarios underpin impact investing arrangements:

1) Investors place capital in a social enterprise or initiative that has a revenue-based business model, thus the potential to generate the necessary cash flow to pay expected returns; or
2) A third party pays investors based on the ability of contracted social enterprise(s) or service provider(s) to deliver specified social outcomes. Broader public and economic benefits are derived from cost savings due to reduced dependency on social services (for example, as a result of reduced recidivism), increased economic participation (for example, unemployed individuals transitioning to full employment status as a result of a skills development program), or improved social service delivery for target populations. This scenario is associated with but not limited to SIBs, for which a government is commonly the third party payer.

The policy interventions necessary to catalyze further investment activity under each scenario are unique.

The exchange mechanisms needed to attract investment in revenue-based enterprises are emerging through initiatives such as the SVX and investment funds offered by Renewal Partners. Continued focused effort is needed to accelerate the pace of development, and to lower barriers to capital deployment, including concerns regarding the risk-return profile of investments.

Interventions are also required for the second scenario, for example, to identify priority social issues and value outcomes; enter into contracts to pay for outcomes; and engage intermediaries to build service provider capacity.

7. GOVERNMENT INITIATIVES TO CATALYZE IMPACT INVESTING

When asked about the role of government, the investors we spoke with expressed varying views on government-led interventions to catalyze the investment of private capital, largely based on their past experiences with government incentive programs.

Overall, a common theme that emerged is the importance of holding a long-term view of success and the desired impact of an intervention. Investors wanted to know upfront the intent of the measure, including whether it would be in place for a fixed period of time, and the criteria for the types of organizations and initiatives that would qualify for incentive programs, in order to concentrate efforts and help to ensure that funding is supporting intended outcomes.

Investors also indicated interest in catalytic measures. For governments to catalyze the market for impact investing, striking the right balance between being responsive to market needs, and being proactive in helping to develop the market is important. Investors would support measures that help offset risk or mitigate losses, such as tax-based incentives, however are cautious about the risk of subsidizing poor investment decisions that would not achieve the broader intent of the measure.

Governments around the world have deployed a number of tools to direct new private capital to the impact investment market, or other priority markets. Broadly, these measures fall into four categories: credit enhancements, tax incentives, direct capital investment, and direct payment for outcomes. Examples of instances in which these tools have been utilized by governments are described in Section 7.1.

7.1 Credit enhancements

Governments can implement credit enhancement initiatives to share capital risk with investors and increase the supply of capital available to impact investment opportunities. The objective is to mitigate the actual or perceived higher risk of impact investments through instruments including junior equity positions structured to take the first loss, grants or guarantees provided for the express purpose of covering a set amount of first-loss, or subordinated debt. [83]

Western Economic Diversification Canada (WD)

WD is a federal government program designed to diversify the economy in Western Canada while improving the quality of life of its citizens. In particular, its Loan and Investment Program has encouraged independent Western Canadian financial institutions to lend to higher-risk small businesses that would otherwise have experienced difficulty in accessing capital. WD contributed funds to share in losses incurred when lending to these higher-risk clients. The program was viewed as a success, with over 3,400 loans approved and $259 million disbursed. Over a five-year period, the program generated $9 in new loans and $19 in investments from other sources for every dollar provided by WD. [84]

Social Enterprise Development and Investment Funds (SEDIF)

In Australia, the SEDIF provides finance solutions to help social enterprises develop, grow, and sustain their work and impact. The SEDIF was seeded through grant funding of AUD$20 million, however fund managers were required to at least match the grant funding with private investment, creating a total investment pool of over AUD$40 million. For example, Christian Super, a small private pension fund, is an anchor investor in the Community Finance Fund – Social Enterprise, which provides secured loans to sophisticated social enterprises. The Australian government, through the SEDIF, matched Christian Super's AUD$6 million investment with an AUD $6 million grant. Of this, AUD$4.5 million is designated to take the first loss, which facilitated Christian Super's investment. The initial capital protection is designed to diminish over time as more limited partners invest in the fund.

7.2 Tax incentives

Tax incentives can offer a reprieve on income taxes to encourage investment in certain sectors, asset classes, corporate structures, or investment vehicles. In addition to encouraging investment, the reduction in taxes payable may also act as a buffer against risk or below market rate returns.

Community Economic Development Investment Fund (CEDIF)

The CEDIF program was designed to stimulate economic growth, provide new employment opportunities, and rejuvenate existing economic sectors in the province of Nova Scotia. CEDIFs are pools of capital formed through the sale of shares to persons in a defined community, which are invested in the creation or expansion of local businesses. The program is built with three distinct policy levers:

- a simplified offering document for seeking equity investment, to help alleviate the cumbersome and expensive transaction process associated with the typical, lengthier investor prospectus;
- a 35 percent income tax credit for investors once their investments have been registered with the Nova Scotia Securities Commission; and
- the ability for investors to register their investments through a self-directed Registered Retirement Savings Plan, which qualifies investors for further federal income tax deductions.

Since its inception in 1999, the total funds raised have grown 572 percent, with the number of investors increasing 250 percent and the total funds invested increasing 92 percent. Only three business ventures out of more than 120 that received investments have failed. This has been attributed to the community-centric governance model which the CEDIF program employs.

Social Investment Tax Relief

To encourage individuals to invest in social enterprises and to help social enterprises access new sources of finance, the UK government recently introduced income tax and capital gains tax relief on investments in qualified organizations. For investments held for a minimum of three years, individuals may deduct 30 percent of the cost of the income tax liability in the year in which the investment is made. Individuals who have earned capital gains may defer tax if the gain is invested in a qualifying social investment opportunity.

7.3 Direct capital investment

Public funds may be deployed to catalyze private investment, fill an underserved gap, or advance investment in priority areas that help to grow the domestic ecosystem. Commonly the government will invest alongside private investors, however the terms of investment may differ.

Ontario Emerging Technologies Fund (OETF)

The OETF is a $250 million fund that co-invests on the same terms, at the same time, with qualified venture capital funds and other qualified investors, directly into innovative, high growth Ontario-based companies. The program was designed to stimulate venture capital and angel investment in clean technology, life sciences, and digital media and information and communication technologies at a time when venture capital returns were low and available investment capital was limited. Eligible investors have driven the investment opportunities, submitting proposals for consideration by a third party investment manager, limiting government intervention in the market.

Bridges Ventures

In 2002, the UK Government provided a £20 million matching investment to Bridges Ventures, part of which was subordinated in that it took the first loss risk and had a capped return, acting as an investment catalyst. Bridges then turned to progressive private equity firms and entrepreneurs – Apax Partners, 3i, Doughty Hanson, and Tom Singh – as initial backers. Bridges closed its first Sustainable Growth Fund at £40 million in May 2002. Based on the results of Fund I, Bridges was able to raise its second fund in 2007 purely from private sector investors, including pension funds and banks. Fund II was oversubscribed at £75 million, substantially more than the original £50 million target. Subsequently, Bridges raised £125 million with Fund III in 2012. Today, Bridges manages £460 million and is building its eighth fund. These funds span three different impact investment areas: Sustainable Growth, Property, and Social Sector.

7.4 Direct payment for outcomes

Also known as payment-by-results or outcomes-based financing, these mechanisms are aimed at redistributing government funding to reward higher levels of impact, verified through measurement of attributable outcomes. The government can take a number of different approaches, including outcomes-based direct contracting with service providers; creation of an outcomes fund to finance outcomes-based contracts or top-up payments for outcomes achieved; or commitments to pay investors based on results achieved. SIBs are one mechanism being explored by governments, which may incorporate a number of these attributes to focus on scaling interventions that address a particular social challenge, engaging private capital in the solution.

New South Wales Social Benefit Bonds

The New South Wales government, in Australia, has entered into two Social Benefit Bond (SBB, also known as SIB) trials. The first is the Newpin SBB, an AUD$7 million bond spanning seven years, funding UnitingCare Burnside's program, which provides support for families to facilitate their child's return from foster care. The Benevolent Society SBB is an AUD$10 million bond with a five-year term, which funds the Resilient Families service, providing intensive support for up to 400 families and children for 12 months, including up to nine months of post-crisis care. The two SBBs differ in their contracting structure, financial structure, and measurement of outcomes, demonstrating the need for flexibility given the unique circumstances of the problem being tackled. Investors included corporations, financial institutions, foundations, individuals, and trusts. A survey undertaken by Social Ventures Australia demonstrated that investments in SBBs are 'new' investments, not simply a diversion of existing philanthropic funds.

Social Outcomes Fund

Launched in November 2012 by the UK Cabinet Office, the £20 million fund tops up funding into new outcomes-based approaches. The objective of the fund is to address the complexity of aggregating benefits and savings that accrue across the complex public sector landscape, and to help to grow the payment-by-results market in the UK.

Taking an outcomes-based approach to structuring returns appeals to the investors interviewed for this part of the report. However, concerns include unfamiliarity with new products such as SIBs, the complexity of the underlying contracting arrangements involving parties with varying interests, and difficulties making the opportunity more readily available to more investors.

8. RECOMMENDATIONS

Government support is needed to help take impact investing to the next level in Canada. Deployment of multiple initiatives would support continued growth and attract new investors. Broadly, federal government leadership, in partnership with provincial and municipal governments, private investors, social entrepreneurs, and intermediaries, will be required to create an enabling tax and regulatory environment, build a pipeline of investment-ready social enterprises, and mobilize new sources of capital. This part of the report is focused on the latter.

The federal government can play a unique role to help coalesce investment opportunities, and send a signal to the broader market, supporting the attraction of new private capital. It should be noted that different categories of investors will respond to different forms of incentives, and that a variety of approaches would therefore be required to attract capital from across the investor landscape.

The government could undertake a number of initiatives to direct private capital towards organizations and projects that are addressing pressing social challenges. Based on a review of existing efforts to catalyze private sector involvement and feedback obtained through expert interviews, the following recommendations reflect initial steps that could be taken by the federal government to engage the investment community.

8.1 Recommendation 3: Establish an impact investing matching program, paired with appropriate incentives.

There are many options for structuring an impact investing matching program. For example, it could be geared towards direct investment opportunities, with the government co-investing directly in organizations alongside private sector investors. This would enable investors to pursue qualified deals that require more capital than currently available, or enable fund managers to close a funding round. Alternatively, the program could support development of a fund of funds which would serve to aggregate investment opportunities in existing Canadian impact investment funds. Investors currently not participating in impact investing could co-invest with the government. Whether the government would invest pari passu or take a subordinate capital position would need to be determined.

In any case, the program should have clearly established criteria to guide eligibility for funding, including measures to help ensure that funding is allocated in support of regional initiatives. Investors interviewed indicated that it is important to have investment opportunities led by investors, and funding decisions made independent of governments, A third party fund manager could be engaged to manage, advise on, and monitor fund activity. Also important to attract new investors is the inclusion of incentives, such as tax credits or first loss capital, as have been employed to catalyze venture capital, to help mitigate risk and transaction costs.

The 2010 Canadian Task Force on Social Finance recommendation of a $20 million investment of first loss capital in existing funds, followed by $20 million per year over four years to create a fund of funds, conditional on matches, remains relevant. While impact investing funds can take varying sizes, a larger scale fund would be necessary to attract large institutional investors, such as pension funds. The appropriate size for a government investment to catalyze impact investing will depend on the objectives and design of the initiative. A sizable investment would, however, be required, to have a catalytic impact with national reach, and to bring new investors into the impact investment market.

8.2 Recommendation 4: Establish an outcomes payment fund

As the impact investing field is building, a broader shift to outcomes-based approaches is influencing government budgeting and procurement. These approaches focus on identifying the interventions that are having the greatest positive impact in addition to supporting the development of innovative ideas that have the potential to achieve superior social outcomes. Investors have a unique role to play, and have expressed interest in participating, however the opportunity for their participation is currently limited.

An outcomes payment fund could be used to catalyze the use of outcomes-based approaches to service delivery. A flexible approach to establishing contracts, whether they take the form of SIBs or other arrangements, is key to enable testing of innovative opportunities and to further investment in proven solutions. Payments could be based on a specified maximum price per outcome as has been done in the UK, enabling the market to respond with innovative solutions. This model would provide organizations with access to capital markets through government commitments to pay for outcomes.

An outcomes payment fund could have significant impact at various sizes; however, the bigger the fund, the stronger the market signal, and the greater the potential impact. UK equivalents have ranged from £20-40 million.

8.3 Supporting recommendations

A number of investors interviewed expect the government to indicate priority social issues to help galvanize efforts to develop both the supply of and demand for capital. Efforts to enhance the visibility, capacity, and investment readiness of organizations seeking funding have also been identified as important to help overcome challenges related to sourcing appropriate investment opportunities.

- The recommended interventions should be paired with support for investment and contract readiness, to develop the pipeline of investment opportunities.

These recommendations focus on specific initiatives to catalyze the investment of new private capital. Other steps that the federal government could take to more broadly support the growth of the impact investing ecosystem include:

- Developing a comprehensive impact investing vision and strategy that identifies initiatives to develop both the supply of and demand for capital as well as the role of intermediaries, coordinating with provincial and municipal governments.
- Engaging in direct discussions with the investor community to understand their perspectives on the opportunity for mainstream institutional investors.

9. CONCLUSION

The recommendations outlined in Section 8 merit further exploration, to develop a focused business case. As with any intervention, caution should be taken to avoid unintended consequences, including diverting existing impact investment capital rather than inviting new capital into the market, at the risk of freezing or stalling existing market activity.

Each of these recommendations could have a catalytic impact on Canada's impact investment market, mobilizing additional private capital for public benefit.

References

1. With some modifications, many of the examples provided in the Executive Summary of this report are drawn from the report State of the Nation: Impact Investing in Canada. They are by no means comprehensive, but are intended to provide a snapshot of impact investment activity from across Canada. Harji, K., Reynolds, J., Best, H., & Jeyaloganathan, M. (2014, March 21). State of the nation: impact investing in Canada. Retrieved August 2, 2014 from MaRS Library: http://www.marsdd.com/mars-library/impact-investing-in-canada-state-of-the-nation/

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7. "Below market rate" is understood, here, to mean an investment that is expected to deliver anywhere from no return, to a return that is not high enough to compensate for the risk of the investment; in other words, an investment that a traditional, profit-motivated investor would be unlikely to make on the same terms.

8. Outcomes-based financing can take a variety of forms, including payment-for-results contracts between governments and service providers and Social Impact Bonds (SIBs) – in which investors provide up-front financing for a particular service, generally delivered by one or more charitable or non-profit organizations, based on the commitment of an outcomes funder (often a government commissioner) to pay investors an agreed-upon amount of money if certain outcomes are achieved. SIBs, in particular, are a relatively new model for funding social services, and there are mixed views on their use in the Canadian context. Lessons from other countries should inform the application of this model in Canada, as should the perspectives and interests of service providers, investors, and governments, or other outcomes funders, on a case-by-case basis.

9. See footnote 7 for this report's working definition of "below market rate" investments.

10. This last category is narrower than it appears, as it is applied based on case law precedent.

11. Qualified donees are organizations that can issue donation receipts for gifts and can receive gifts from registered charities. Qualified donees include:

    • "a registered charity (including a registered national arts service organization);

    • a registered Canadian amateur athletic association;

    • a listed housing corporation resident in Canada constituted exclusively to provide low-cost housing for the aged;

    • a listed Canadian municipality;

    • a listed municipal or public body performing a function of government in Canada;

    • a listed university outside Canada that is prescribed to be a university, the student body of which ordinarily includes students from Canada;

    • a listed charitable organization outside Canada to which Her Majesty in right of Canada has made a gift;

    • Her Majesty in right of Canada or a province; and

    • the United Nations and its agencies."

    An organization's own charitable activities can either be carried out by the charity itself or through an intermediary. When a charity uses a non-qualified donee as an intermediary, it must maintain direction and control even if day-to-day operations are delegated, such that the activities amount to activities carried on by the charity itself. Canada Revenue Agency. (2011, August 15). Qualified donees (Guidance No. CG-010). Retrieved August 2, 2014 from Canada Revenue Agency: http://www.cra-arc.gc.ca/chrts-gvng/chrts/plcy/cgd/qlfddns-eng.html; Canada Revenue Agency. (2011, June 20). Using an intermediary to carry out a charity's activities within Canada (Guidance No. CG-004). Retrieved August 2, 2014 from Canada Revenue Agency: http://www.cra-arc.gc.ca/chrts-gvng/chrts/plcy/cgd/ntrmdry-eng.html

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15. Imagine Canada. (n.d.), Key facts about Canada's charities.

16. Canada Revenue Agency. (2014). Non-profit organization risk identification project report. Retrieved August 2, 2014 from Canada Revenue Agency: http://www.cra-arc.gc.ca/tx/nnprft/nprft-prjct-rprt-eng.html

17. An effective business plan for generating revenue is usually necessary to attract investment capital. An important exception exists in the case of Social Impact Bonds (SIBs), which allow NPOs and charities to access capital markets based on a government commitment to pay for certain outcomes. While they are a significant part of the global impact investment landscape, SIBs are not a primary focus of this part of the report.

18. Examples of hybrid corporate forms include the Community Interest Company (CIC) in the United Kingdom; the Benefit Corporation, Low-Profit Limited Liability Company, and Flexible Purpose Corporation in the United States; and Community Contribution Company (C3) in British Columbia. CIC legislation has also been passed in Nova Scotia.

19. Canada Revenue Agency. (2003, March 31). What is a related business? (Policy Statement No. CPS-019). Retrieved August 2, 2014 from Canada Revenue Agency: http://www.cra-arc.gc.ca/chrts-gvng/chrts/plcy/cps/cps-019-eng.html#N102AD

20. Ibid. Foundations cannot acquire more than 50 percent of the voting shares of a taxable subsidiary, unless they are donated.

21. Canada Revenue Agency. (2006, March 10). Guidelines for registering a charity: meeting the public benefit test (Policy Statement No. CPS-024). Retrieved August 2, 2014 from Canada Revenue Agency: http://www.cra-arc.gc.ca/chrts-gvng/chrts/plcy/cps/cps-024-eng.html; Canada Revenue Agency. (2012, July 26). Community economic development activities and charitable registration (Guidance No. CG-014). Retrieved August 2, 2014 from Canada Revenue Agency: http://www.cra-arc.gc.ca/chrts-gvng/chrts/plcy/cgd/cmtycnmcdvpmt-eng.html

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23. Canada Revenue Agency. (2009, November 5). Document No. 2009-0337311E5. Retrieved August 2, 2014 from Video Tax News: http://www.videotax.com/docs/techinter/341/2009-0337311E5.pdf

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27. Government of Canada. (2014). Budget 2014: Annex 2 – tax measures: supplementary information. Retrieved August 2, 2014 from Government of Canada: http://www.budget.gc.ca/2014/docs/plan/anx2-1-eng.html

28. The term PRI is used differently in the United States, encompassing a broader range of impact investing activity than the Canadian definition.

29. "In this situation, the opportunity costs of PRIs are calculated as follows:

    • Loans: the outstanding loan multiplied by the difference between the interest rate the investor charity could have earned if it invested the amount in T bills or GICs, and the interest rate the charity received.

    • Share purchase: the difference between the return the investor charity could have realized had it invested in T bills or GICs and the actual return or loss from purchasing shares.

    • Lease: the difference between the fair market value of the lease and the actual amount the investor charity received from the lease."

    Canada Revenue Agency. (2012, July 26). Community economic development activities and charitable registration (Guidance No. CG-014). Retrieved August 2, 2014 from Canada Revenue Agency: http://www.cra-arc.gc.ca/chrts-gvng/chrts/plcy/cgd/cmtycnmcdvpmt-eng.html

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31. Ibid. For example, Ontario's Trustee Act sets out the following criteria that must be considered by a trustee:

    • "General economic conditions;

    • The possible effect of inflation or deflation;

    • The expected tax consequences of the investment decision or strategy;

    • The role that each investment or course of action plays within the overall trust portfolio;

    • The expected total return from income and the appreciation of capital;

    • Needs for liquidity, regularity of income and preservation or appreciation of capital; and

    • An asset's special relationship or value, if any, to the purpose of the trust or its beneficiaries."

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