
THE ONTARIO BAR ASSOCIATION

Apples, Oranges or Lemons? Legal Issues Arising in the Form, Function and Fundraising of Charitable and Not-for-Profit Organizations

Toronto – October 27, 2004

SHARE CAPITAL SOCIAL CLUBS AS NPOs: ISSUES TO CONSIDER

By Terrance S. Carter, B.A., LL.B., and Theresa L.M. Man, B.Sc., M.Mus., LL.B.

© 2004 Carter & Associates

CARTERS.ca

CARTER & ASSOCIATES
PROFESSIONAL CORPORATION

BARRISTERS, SOLICITORS & TRADE-MARK AGENTS
Affiliated with Fasken Martineau DuMoulin LLP

Main Office Location

211 Broadway, P.O. Box 440
Orangeville, ON, Canada, L9W 1K4
Tel: (519) 942-0001
Fax: (519) 942-0300
Toll Free: 1-877-942-0001

www.carters.ca

National Meeting Locations

Toronto (416) 675-3766
Ottawa (613) 212-2213
London (519) 937-2333
Vancouver (877) 942-0001
"Proactive Advice"®

www.charitylaw.ca

SHARE CAPITAL SOCIAL CLUBS AS NPOs: ISSUES TO CONSIDER

TABLE OF CONTENTS

A. INTRODUCTION	1
B. ISSUES UNDER THE CORPORATIONS ACT (ONTARIO)	3
1. Not Under the Jurisdiction of the <i>Business Corporations Act</i> (Ontario)	3
2. Nature of Public Share Capital Corporations Under the OCA	4
3. Obligations of Public Social Clubs Under the OCA	5
a) Auditing requirements	5
b) Insider trading reporting requirements	6
c) Proxies and information circular disclosure requirements	7
C. ISSUES UNDER THE SECURITIES ACT (ONTARIO)	10
1. When is a Public Social Club Subject to the OSA	10
a) Trade in Securities	11
b) Trade	12
2. Exemptions Under the OSA	14
a) Exemption from registration requirement	14
b) Exemption from prospectus requirement	18
c) Possible relief from the Ontario Securities Commission	19
3. Other Compliance Requirements Under the OSA	19
a) Reporting issuer	19
b) Periodic disclosure requirements	20
c) Insider reporting obligations	20
4. Sanctions Under the OSA for Non-Compliance	20
D. ISSUES UNDER THE INCOME TAX ACT AND CORPORATIONS TAX ACT (ONTARIO)	21
1. The Importance of Maintaining NPO Status	21
2. Status of Public Social Clubs as NPOs Under the ITA	22
a) Legislative requirements under the ITA	22
b) Consequences of losing NPO status under the ITA	23
c) Public Social Clubs as NPOs under the ITA	23
3. Status of Public Social Club as NPOs Under the CTA	37
a) Legislative requirements under the CTA	37
b) Consequences of losing NPO status under the CTA	37
c) Issues of concern to the status of Public Social Clubs as NPOs under the CTA	38
E. ISSUES INVOLVING SHAREHOLDERS	40
1. Equity of the Shares Held by Shareholders	40
2. Issues Regarding Non-Member Shareholders	40
a) Method of providing notice of shareholders' meetings	41
b) Quorum requirements at shareholders' meetings	41
c) Resolution adoption requirements	42
d) Maintaining control by active member shareholders	42
F. CONVERSION INTO NON-SHARE CAPITAL CORPORATIONS	43
G. CONCLUSION	46

THE ONTARIO BAR ASSOCIATION
Apples, Oranges or Lemons?
Legal Issues Arising in the Form, Function and Fundraising of Charitable and
Not-for-Profit Organizations
October 27, 2004

SHARE CAPITAL SOCIAL CLUBS AS NPOs:
ISSUES TO CONSIDER

By **Terrance S. Carter and Theresa L.M. Man***
© 2004 Carter & Associates

A. INTRODUCTION

There are many “social clubs” in Ontario, which term, for the purposes of this paper, is meant to include clubs such as country clubs, golf clubs, tennis clubs, flying clubs, curling clubs, bowling clubs, ski clubs, lawn bowling clubs, boating clubs, yacht clubs, swimming clubs, soccer clubs, badminton clubs, recreational clubs and fraternal clubs, etc. Some of these clubs are organized as share capital corporations under the *Business Corporations Act*¹ (Ontario) (the “OBCA”). The vast majority of these clubs are organized as non-share capital corporations under either the *Corporations Act*² (Ontario) (the “OCA”) or the federal *Canada Corporations Act*³.

A recent search of the database at the Companies and Personal Property Security Branch (the “Companies Branch”) of the Ministry of Consumer and Business Services (the “MCBS”) indicates that approximately four hundred social clubs in Ontario are organized as share capital corporations under either the OCA or applicable federal legislation. More than 50% of these share capital social clubs are organized under the OCA.

Often, the historical reason for structuring social clubs as share capital corporations has arisen because of a need to raise funds for capital and operational needs for the clubs. These social clubs

*The authors would like to thank Alan M. Schwartz, Q.C. and Eric C. Belli-Bivar, partners with the law firm of Fasken Martineau DuMoulin LLP, for their assistance and advice regarding the underlying research and analysis reflected in this paper. The authors would also like to thank D. Ann Walters, student-at-law of Carter & Associates, for assisting in the preparation of this paper. Any errors are solely those of the authors.

¹ R.S.O. 1990, c. B.16.

² R.S.O. 1990, c. C.38.

³ R.S. 1970, c. C-32.

are unable to become registered charities due to the social nature of their objects and their objects are not exclusively charitable. Therefore, it is not possible for these social clubs to raise funds by soliciting donations. As an alternative to, or sometimes as a supplement to membership and initiation fees, social clubs that are structured as share capital corporations are also able to raise funds by soliciting subscription for shares in the clubs to prospective members. This has meant that share capital social clubs will often seek to have a large base of shareholders. As a result, many of these share capital social clubs are organized as public share capital corporations rather than private share capital corporations, since the restriction of private share capital corporations to fifty shareholders or less would not be a sufficient base from which these clubs could raise the funds necessary to operate beyond that which they can raise by debt financing or initiation fees. In so doing, the subscription of shares from these social clubs will often become a significant, if not the primary, means of raising funds for those clubs.

The requirements under the OCA and the *Securities Act* (Ontario)⁴ (the “OSA”) concerning public share capital corporations are generally applicable to these clubs, notwithstanding that some of these clubs also operate as non-profit organizations (“NPO”) under the *Income Tax Act*⁵ (the “ITA”) and the *Corporations Tax Act* (Ontario)⁶ (the “CTA”). However, there are a number of unique issues faced by social clubs that operate as NPOs but have decided for various historical reasons to utilize a public share capital corporation structure as their corporate vehicle.

In this paper, social clubs that operate as NPOs and which are organized as public share capital corporation structure under the OCA are referred to as “Public Social Clubs” in describing the issues that are discussed in this paper under the OCA, the OSA, the ITA and the CTA. A discussion of public share capital corporations under the *Canada Corporations Act* or private social clubs is beyond the scope of this paper.

⁴ R.S.O. 1990, c. S.5.

⁵ R.S.C. 1985, c. 1 (5th Supp.).

⁶ R.S.O. 1990, c. C.40.

B. ISSUES UNDER THE CORPORATIONS ACT (ONTARIO)

1. Not Under the Jurisdiction of the *Business Corporations Act* (Ontario)

At the outset, it is important to point out why Public Social Clubs do not fall under the jurisdiction of the OBCA. Most Public Social Clubs were incorporated prior to the enactment of the OBCA in 1971. At that time, the OCA was the only Ontario corporate statute under which all corporations, whether share capital or non-share capital, could incorporate. On January 1, 1971, a new *The Business Corporations Act, 1970* (Ontario)⁷ came into force, which statute was later amended in 1983. All corporations that were incorporated under the OCA came under the jurisdiction of the OBCA in 1971, save and except the specific exceptions set out in subsection 2(2)(a) of the 1970 OBCA, which provides that the OBCA does not apply to “a company within the meaning of the Corporations Act and has objects in whole or in part of a social nature.” This provision is the predecessor to the subsection 2(3)(a) of the current OBCA. As a result, Public Social Clubs, by virtue of having objects that are of a “social nature,” continue to be under the jurisdiction of the OCA after the enactment of the OBCA in 1971. This also means that since 1971, it is no longer possible to incorporate social clubs as share capital corporations under the OCA. All social clubs today must be incorporated as non-share capital corporations under the OCA.

The term “social” is not defined in the OCA or the OBCA. However, the MCBS has generally given the term a broad interpretation. According to Donald Bourgeois, in his book “The Law of Charitable and Non-profit Organizations”⁸, “without evidence to the contrary, athletic, sporting, recreational, fraternal and similar organizations will be considered to have objects that are in whole or in part, social in nature.” In determining whether a social club qualified for relief from municipal tax assessment, the courts in *Unicity Racquet Club Ltd. v. Winnipeg (City)*⁹ relied on the Oxford Dictionary definition of “social”. Under this definition, “social” means “marked or characterized by mutual intercourse, friendliness or geniality, enjoyed, taken, spent, etc., in company with others, especially with those of a similar class or kindred interests.” These definitions suggest that as long as a social club was established to

⁷ *S.O. 1970, c.25.*

⁸ Donald Bourgeois, *The Law of Charitable and Not-for-Profit Organizations*, 3rd. ed (Canada: Butterworths, 2002).

⁹ [1991] M.J. No. 40.

provide sporting, recreational, fraternal, athletic facilities for its members, it would likely fall within the meaning of a “social club” referred to in subsection 2(3) of the OBCA and therefore would fall outside the jurisdiction of the OBCA.

2. Nature of Public Share Capital Corporations Under the OCA

Section 1 of the OCA defines “company” as a “corporation with share capital”. A “corporation” under section 1 of the OCA means a “corporation with or without share capital”. Therefore, the term “corporation” may refer to either (1) a share capital corporation, which may be either (a) a “private company” or (b) a “public company”, or (2) a non-share capital corporation.

Section 1 of the OCA defines “public company” as a corporation that is not a “private company”. A “private company” is defined in section 1 of the OCA as follows:

A Company as to which by its special Act, letters patent or supplementary letters patent,
(a) the right to transfer its shares is restricted,
(b) the number of its shareholders, exclusive of persons who are in the employment of the Company, is limited to fifty, two or more persons holding one or more shares jointly being counted as a single shareholder, and
(c) any invitation to the public to subscribe for its shares or securities is prohibited..

Accordingly, a private share capital company is required to satisfy all three requirements as described above, otherwise the company is deemed to be a “public company”, i.e. a public share capital corporation. Since the public corporation structure is generally utilized by Public Social Clubs in order to raise funds, it would not be appropriate for Public Social Clubs to restrict the number of shareholders to fifty. However, it is interesting to note that there is no prohibition under the OCA against Public Social Clubs including provisions in their letters patent to impose restrictions on the right to transfer shares of Public Social Clubs or to prohibit an invitation to the public to subscribe in shares of those clubs. If such restrictions or prohibitions were not included in the letters patent of Public Social Clubs, then, unlike private corporations, the shares of Public Social Clubs could be bought and sold in the open market

and an invitation could be extended to the public to subscribe for shares in Public Social Clubs, subject in each case to the requirements of the OSA. However, the ability of the shares of Public Social Clubs to be traded publicly means that issuing shares by Public Social Clubs imposes compliance requirements under both the OCA and the OSA.

3. Obligations of Public Social Clubs Under the OCA

As public share capital corporations, there are corporate requirements that Public Social Clubs need to comply with under the OCA, including auditing requirements, insider trading reporting requirements, and proxies and information circular disclosure requirements. These obligations are set out below.

a) Auditing requirements

Public share capital corporations under the OCA are required to comply with detailed auditing requirements under the OCA than those which apply to private companies and non-share capital corporations. Specifically, sections 97 to 111 of the OCA requires that the following financial statements be prepared by an auditor of a public share capital corporation in addition to the requirements imposed upon private share capital corporations:

- a statement of profit and loss for each period that includes a statement of “sales or gross operating revenue”;
- a statement of source and application of funds for each period, and
- interim financial statements for the six-month period after the fiscal year end, which statements must be sent to its shareholders within 60 days of the end of the said six-month period.

It is important therefore to be aware of these stringent requirements and to ensure they are complied with within the requisite time frame.

b) Insider trading reporting requirements

Subsection 72(1) of the OCA provides that an “insider” is, *inter alia*, anyone who is a director or senior officer of a public share capital corporation that has fifteen or more shareholders. “Senior officer” means “(a) the chair or any vice-chair of the board of directors, the president, any vice-president, the secretary, the treasurer or the general manager of a Company or any other individual who performs functions for the Company similar to those normally performed by an individual occupying any such office, and (b) each of the five highest paid employees of a Company, including any individual referred to in clause (a)”. As long as the threshold requirement of fifteen or more shareholders is met, the directors and senior officers of Public Social Clubs would technically be “insiders” under the OCA.

Subsection 73(1) of the OCA imposes on-going reporting requirements on an insider to file a report on the insider’s “direct and indirect beneficial ownership of or control or direction over capital securities” of the corporation with the Ontario Securities Commission (the “Commission”). Accordingly, all directors and senior officers (including the five highest paid employees, if any) of Public Social Clubs are technically required to file insider reports with the Commission if they own securities (i.e. shares) in the Public Social Clubs, either directly or through indirect beneficial ownership.

However, it is doubtful whether directors or senior officers of Public Social Clubs comply with these requirements, given the not-for-profit nature of their organizations. In this regard, the rationale behind the filing requirement for insiders is to prevent individuals from personally benefiting from confidential information that an insider may obtain that may affect the value of the shares of the corporation. This is intended to protect the public from controlling individuals within a corporation receiving profits or being protected from losses based upon knowledge that they would have in being in a position of power within the corporation. However, the potential to benefit from insider information is not a factor for NPOs and therefore the public policy reason for insider trading requirements under the OCA should not apply to Public Social Clubs. The fact

that directors and senior officers of Public Social Clubs are technically subject to insider reporting requirements to protect the public from possible inappropriate profits is not consistent with the status and operations of Public Social Clubs as NPOs under both the ITA and the CTA. An amendment to the OCA to recognize this fact is therefore necessary.

c) Proxies and information circular disclosure requirements

As public share capital corporations under the OCA, Public Social Clubs are also required to comply with detailed proxy requirements under the OCA each time a meeting of the shareholders is called. Under sections 85, 86 and 87 of the OCA, a Public Social Club is required to solicit proxies by providing a detailed information circular to its shareholders, with strict requirements on the form of proxy to be used pursuant to section 88 of the OCA, unless exemption from compliance with sections 85 and 86 is granted by the Commission under subsection 87(2) of the OCA.

Sections 83 to 90 of the OCA set out specific and detailed requirements of what information would need to be contained in the proxies, including the following examples:

- Certain information must be indicated in bold-face type, such as “whether or not the proxy is solicited by or on behalf of the management of the company” and “that the shareholder has the right to appoint a person to attend and act for the shareholder and on the shareholder's behalf at the meeting¹⁰ other than the person, if any, designated in the form of proxy.”
- The proxy must “provide a specifically designated blank space for dating the form of proxy.”¹¹
- The proxy “shall provide means whereby the person whose proxy is solicited is afforded an opportunity to specify that the shares registered in the person's name

¹⁰ OCA, *supra*, note 2, subsection 84(1).

¹¹ OCA, *supra*, note 2, paragraph 88(a)(ii).

shall be voted by the nominee in favour of or against, in accordance with such person's choice, each matter or group of related matters identified therein or in the information circular as intended to be acted upon, other than the election of directors and the appointment of auditors, provided that a proxy may confer discretionary authority with respect to matters as to which a choice is not so specified by such means if the form of proxy or the information circular states in bold-face type how it is intended to vote the shares represented by the proxy in each such case.”¹²

- The proxy “may confer discretionary authority with respect to (i) amendments or variations to matters identified in the notice of meeting, or (ii) other matters which may properly come before the meeting, provided that, (iii) the person by whom or on whose behalf the solicitation is made is not aware a reasonable time prior to the time the solicitation is made that any such amendments, variations or other matters are to be presented for action at the meeting, and a specific statement is made in the information circular or in the form of proxy that the proxy is conferring such discretionary authority”¹³.
- “No proxy shall confer authority (i) to vote for the election of any person as a director of the company unless a nominee proposed in good faith for such election is named in the information circular, or (ii) to vote at any meeting other than the meeting specified in the notice of meeting or any adjournment thereof.”¹⁴

Furthermore, sections 30 and 31 of Regulation 181 of the OCA contain detailed requirements concerning the information circular that must be provided by Public Social Clubs to their shareholders each time a shareholders’ meeting is called. Although many required items under the OCA may not be relevant to most Public Social Clubs’ situation, the requirements must nevertheless be complied with to the extent possible.

¹² OCA, *supra*, note 2, subsection 88(b).

¹³ OCA, *supra*, note 2, subsection 88(c).

¹⁴ OCA, *supra*, note 2, subsection 88(d).

Examples of some of the detailed disclosure to be made in the information circular include the following:

- The information circular must be prepared in accordance with Form 16 set out in the Regulations. The information required by Form 16 must be given “as of the date specified in the circular”, which date shall not be more than thirty days before the circular is sent to the shareholders.
- The information contained in the information circular “shall be clearly presented and the statements contained therein shall be divided into groups according to subject-matter and each group of statements shall be preceded by an appropriate heading.”
- Information that is “not known by or is unavailable to the person on whose behalf an information circular is prepared and that is not reasonably within the power of that person to ascertain or obtain may be omitted” only if “a brief statement is made in the information circular indicating the reasons why the information is not known or is unavailable.”
- A copy of the “information circular, proxy and all other materials sent or delivered” to the shareholders must be filed with the Commission.
- In relation to the election of directors, very specific information concerning the slate of candidate must be set out in the information circular, including the term of office for proposed directors, names of individuals on executive committee of the board of directors and audit committee, the occupation, business or employment of each director and proposed director, the number of all equity shares held by each director, etc.
- There are also specific disclosure requirements concerning the remuneration of directors and officers.

C. ISSUES UNDER THE SECURITIES ACT (ONTARIO)

The main objectives of the OSA to foster public confidence and to optimize allocation of resources in the economy are achieved primarily by the following ways:

- ♦ by imposing disclosure requirements (primary and continuous) through a prospectus requirement; and
- ♦ by imposing requirements to register market actors such as brokers and dealers through a registration process.

In this regard, subsection 25(1) of the OSA requires that any person or company that trades in securities is obliged to register with the Commission unless exempted. The triggering fact is whether an organization is involved in carrying on a “trade.” In addition to the registration requirement, there is a basic prohibition in subsection 53(1) of the OSA. Under this prohibition, “no person or company shall trade in a security on his own account or on behalf of any person or company where such as trade would be a distribution of such security, unless a preliminary prospectus and a prospectus have been filed and receipts thereof obtained from the Director.” Therefore, as long as there is a “trade” in a “security” which constitutes a “distribution”, the person or company doing so must prepare and deliver a prospectus to the purchasers and file this with the Commission.

1. When is a Public Social Club Subject to the OSA

Under the OSA, anyone who “trades” in “securities” is required to comply with the registration requirement as well as the prospectus requirement in the event of a “distribution” of these securities, subject to certain exceptions. A “distribution” is defined in subsection 1(1) of the OSA and may arise under three situations (1) where an issuer intends to issue previously unissued securities, (2) where any person who is a “control person” of an issuer (i.e. generally refers to someone holding more than 20% of the voting securities of the issuer) disposes of his/her securities of that issuer, and (3) where there is a trade by or on behalf of an issuer in previously issued securities of that issuer that have been redeemed by, purchased by or donated to the issuer. The registration requirement refers to statutory rules requiring trades

of securities to be effected through a securities firm that is registered (i.e. licensed) under the OSA. The prospectus requirement refers to the rules that require a person or company that trades in securities, where such a trade would be a distribution of such securities, to be undertaken only if the person or company prepares and delivers a prospectus to the purchasers, and files the same with the Commission.

a) Trade in Securities

The first issue is whether Public Social Clubs “trade” in securities. If so, Public Social Clubs would be obligated to comply with the various statutory requirements under the OSA, unless it is otherwise exempt from compliance with these requirements under the OSA.

“Securities” is defined very broadly under subsection 1(1) of the OSA to include sixteen branches and the more significant ones include, *inter alia*, the following:

(a) any document, instrument or writing commonly known as a security;

...

(b) any document constituting evidence of title to or interest in the capital, assets, property, profits, earnings or royalties of any person or company;

...

(h) any certificate of share or interest in a trust, estate or association.

(n) any investment contract

The definition of “security” captures a broad range of financing techniques. As such, any profit sharing agreement, any contract whereby a person invests¹⁵, and any document of title to any property¹⁶ will likely be considered a security. In *Pacific Coast Coin Exchange of Canada v. Ontario (Securities Commission)*¹⁷, in determining what qualifies as an “investment contract” the Supreme Court of Canada adopted a broad

¹⁵ *S.E.C. v W.J. Howey Co.*, 328 U.S. 293 (1946).

¹⁶ *Re Ontario Securities Commission and Brigadoon Scotch Distributors (Canada) Ltd.*, [1970] 3 O.R. 714-717.

¹⁷ [1978] 2 S.C.R. 112.

purposive approach in interpreting the word “security”. The courts held that the term investment contract must be interpreted to fulfill the statutory purpose of compelling full and fair disclosure relative to the issuance of instruments that fall within the concept of security. More importantly the courts stated a standard that should be applied in determining what is a security:

I have examined the facts in the sole light of the *Howey* and *Hawaii* tests...however, I would be inclined to take a broader approach. It is clearly legislative policy to replace the harshness of caveat emptor in security related transactions and the Courts should seek to attain that goal even if tests carefully formulated in prior cases prove ineffective and must continually be broadened in scope. It is the policy and not the subsequently formulated judicial test that is decisive...

The prevailing principle that comes out of this case is that in defining what is a security, the courts will focus on investor protection and broadly construe the provision. Substance will likely take precedence over form.

As such, pursuant to the above, the shares issued by Public Social Clubs would fall within the definition of “securities” under the OSA.

b) Trade

If a Public Social Club “trades” in its shares, then the Public Social Club would be required to comply with the registration and prospectus requirements under the OSA. The term “trade” is also very broadly defined in subsection 1(1) of the OSA. A “trade” would include, *inter alia*, the following:

- (a) any sale or disposition of a security for valuable consideration ...;
- (b) any participation as a trader in any transaction in a security through the facilities of any stock exchange or quotation and trade reporting system;
- (c) any receipt by a registrant to buy or sell a security;

(d) any transfer, pledge or encumbrancing of securities of an issuer from the holding of any person or company or combination of persons or companies described in clause (c) of the definition of “distribution” for the purpose of giving collateral for a debt made in good faith; and

(e) any act, advertisement, solicitation, conduct or negotiation directly or indirectly in furtherance of any of the foregoing.

Generally, the phrase “valuable consideration” has been interpreted in the contract law context as:

A valuable consideration, in the sense of the law, may consist either in some right, interest, profit, or benefit accruing to the one party, or some forbearance, detriment, loss, or responsibility, given, suffered, or undertaken by the other.¹⁸

The *New Brunswick (Security Frauds Prevention Act, Administrator) v. Reid*¹⁹ decision is indicative of how the term “valuable consideration” might be defined in the securities law context. Justice Glennie in this case addressed whether contemplated consideration was enough to trigger a trade for the purposes of the *Securities Act (New Brunswick)*²⁰, and stated the following:

It is to be observed that the definition of trade “includes” the acts contained in the definition. It is not restricted to these activities. As well, the definition of “trade” does not provide that the consideration must flow to the individual selling the security. ...Securities Regulation is remedial, not punitive. Accordingly a broad flexible interpretation is appropriate. Actual consideration is not required, contemplated consideration is sufficient. Thus a trade may occur before the consideration has actually been exchanged between the parties.

Unfortunately, the Commission has not dealt with this issue in particular in any of its decisions. Based on this definition, if for example, shares of a Public Social Club are issued for valuable consideration to new shareholders or consideration is contemplated,

¹⁸ *Hubbs v Black*, [1918], O.J. No. 48.

¹⁹ [2001] N.B.J. No. 128.

²⁰ S.N.B. 2004, c. S-5.5.

it follows that the Public Social Club in question would be “trading” in “securities” and would be required to comply with the registration and prospectus requirements under the OSA, unless otherwise exempted as discussed below.

2. Exemptions Under the OSA

The exemptions from registration and prospectus requirements under the OSA that would apply to Public Social Clubs are outlined below as follows:

a) Exemption from registration requirement

Subsection 35(1) of the OSA sets out a list of enumerated “trades” that are exempt from the registration requirement. Subsection 35(2) of the OSA contains a list of enumerated “securities” that are exempt from the registration requirement. If either of the exemption provisions under subsection 35(1) or subsection 35(2) applies to a Public Social Club, then the Public Social Club would be exempt from complying with the registration requirement under the OSA.

Of the 15 “securities” exemptions listed under subsection 35(2), paragraph 35(2)10 provides that “securities of a private company where they are not offered for sale to the public” are exempt. “Private company” is defined in subsection 1(1) of the OSA. This definition is very similar to the definition of “private company” in section 1 of the OCA. This exemption is not available to Public Social Clubs because they are not private companies.

Paragraph 35(2)7 of the OSA provides an exemption from the requirement to register if the securities are “issued by an issuer organized exclusively for educational, benevolent, fraternal, charitable, religious or recreational purposes and not for profit, where no commission or other remuneration is paid in connection with the sale thereof”. The three main criteria for exemption under paragraph 35(2)7 can be summarized as follows:

- The issuer is “organized exclusively for educational, benevolent, fraternal, charitable, religious or recreational purposes”;
- The issuer is “not-for-profit”; and
- No commission or other remuneration is paid in connection with the sale of securities of the issuer.

If the shares of a Public Social Club satisfy all of the above criteria, then the Public Social Club would be exempt from the registration requirements under the OSA. In any event, it is arguable that the spirit behind the OSA should not result in requiring a Public Social Club to register and file a prospectus under the OSA. Section 1.1 of the OSA provides that the purposes of the OSA are “(a) to provide protection to investors from unfair, improper or fraudulent practices; and (b) to foster fair and efficient capital markets and confidence in capital markets.” Neither of these purposes are relevant to the operations of Public Social Clubs.

However, unless it can be shown that the Public Social Club in question meets all aspects of the exemption under paragraph 35(2)7 of the OSA, it is possible that a Public Social Club would have to comply with the provisions of the OSA. Therefore, if any one of the three criteria described in more detail below is not met, then the Public Social Club would be required to comply with the registration requirement under the OSA.

i) Organized exclusively for certain purposes

The first criteria under paragraph 35(2)7 of the OSA requires that the issuer is “organized exclusively for educational, benevolent, fraternal, charitable, religious or recreational purposes”. Since this provision of the OSA has listed six purposes to which this provision applies, and is not extended by inclusive language, it would appear that the list is intended to be exhaustive. This means that in order to satisfy these criteria, the corporation in question must be organized exclusively for one or more of the six enumerated purposes.

In this regard, it is important to note that under paragraph 149(1)(l) of the ITA, one of the four criteria that must be satisfied by an NPO is that the organization in question must be “organized exclusively for social welfare, civic improvement, pleasure, recreation or any other purpose except profit.” The four purposes listed in paragraph 149(1)(l) of the ITA are not exhaustive because “any other purpose except profit” carried on by the corporation in question would also be acceptable under the ITA. Accordingly, a corporation that qualifies as an NPO under the ITA may not necessarily be exempt from compliance with the OSA under paragraph 35(2)7. This means that although a Public Social Club claims NPO status under both the ITA and the CTA, an examination under the OSA is still required to determine whether the objects of the Public Social Club as stated in its letters patent are within the six enumerated purposes set out in paragraph 25(2)7 of the OSA,

ii) “Not-for-profit” or “organized not-for-profit”

In relation to the “not-for-profit” criteria under paragraph 35(2)7 of the OSA, the drafting of the legislation is unclear concerning whether the word “organized” is only with respect to the six enumerated purposes of the issuer or whether this word is also to be read with respect to the word “not-for-profit”. The first interpretation would require the issuer to be both “organized” and “operated” not-for-profit. The latter interpretation would imply that the issuer is required to be “organized not-for-profit”, and not necessarily required to be operated not-for-profit.

The first interpretation would appear to be consistent with the decision reached by the Commission in *Sky Larks Society Inc.*, [*Sky Larks*]²¹ In that case, the Commission held that a public share capital corporation that was incorporated under Part II of the OCA exclusively for educational and recreational purposes was not exempt from the OSA because the corporation in question was not in fact operating not-for-profit. This decision is confirmed by the decision of the Ontario

²¹ June, 1967 OSCB 21.

Court (Provincial Division) in 1990 in the case of *R v. Chering Services Inc.*, [*Chering*]²² where the corporation in question was a non-share capital corporation organized under Part II of the *Canada Corporations Act* for research or educational purposes and was not-for-profit. The court held that the non-share capital corporation in question was trading in securities because of the way the corporation acted as a conduit for monies its members wished to lend to finance the sale of a product on a profitable basis. The court held that although the corporation was organized for research or educational purposes and not-for-profit, the fact that it did not operate as such precluded the corporation from relying upon the exemption from compliance with the OSA. This decision means that in order to be exempted under paragraph 35(2)7 of the OSA, the issuer will need to be both organized and operated not-for-profit.

(1) Organized not-for-profit

Although there are two possible interpretations in relation to the “not-for-profit” criteria under paragraph 35(2)7 of the OSA, both interpretation would require Public Social Clubs to be “organized not-for-profit”. Some issues to consider in this regard would include the following:

- Is the Public Social Club organized not-for-profit? Is there any provision in the letters patent that requires the Public Social Club to operate on a not-for-profit or cost-recovery basis? In this regard, although the Companies Branch currently does not permit the insertion of a clause in the letters patent of a Public Social Club requiring the Public Social Club to operate on a non-profit basis, the Companies Branch does permit the insertion of a clause in the letters patent requiring the Public Social Club to operate on a “cost recovery basis.”
- Are the shareholders of the Public Social Club entitled to receive dividends if and when declared by the Public Social Club? Are there

²² December 7, 1990 OSCB 5147 (Ont. Prov. Div.).

any restrictions in the letters patent, by-laws or elsewhere on the Public Social Club regulating the declaration and payment of dividends?

(2) Operated not-for-profit

As explained above, other than the “organizational” requirement, it is possible that there is an “operational” not-for-profit element to the exemption provision in paragraph 35(2)7 of the OSA. This is consistent with the decisions reached by the Commission in the *Sky Larks*²³ case as well as the *Chering*²⁴ case. In both cases, it was decided that even though a corporation was organized exclusively for one or more of the six enumerated purposes as set out in paragraph 35(2)7 of the OSA, it might not be exempt from compliance with the OSA if the corporation was not in fact operating not-for-profit.

iii) No commission

Paragraph 35(2)7 of the OSA also requires that “no commission or other remuneration is paid in connection with the sale thereof”. It seems that as long as no commission is paid or is payable, either directly or indirectly, upon the transfer of the shares of a Public Social Club, it would appear that this requirement will be satisfied. However, it is a question of fact whether a commission might be payable in a particular situation and therefore should be carefully reviewed in each case.

b) Exemption from prospectus requirement

If a Public Social Club does not qualify for the registration exemption under paragraph 35(2)7 of the OSA and the corresponding prospectus exemption in section 73 of the OSA, then any distribution of the Public Social Club’s shares would require compliance with the prospectus requirement under the OSA. Any decision to distribute shares that do not qualify for an exemption should be thoroughly reviewed given the costs

²³ *Sky Larks*, *supra*, note 21

²⁴ *Chering*, *supra*, note 22

associated with prospectus filing. On the other hand, if a Public Social Club does qualify for the exemption from registration requirement under paragraph 35(2)7 of the OSA, it would be entitled to an exemption from filing a prospectus under section 73 of the OSA.

c) Possible relief from the Ontario Securities Commission

If a Public Social Club is not exempt from registration under paragraph 32(2) of the OSA, then the Public Social Club may seek, upon application, a ruling from the Commission under subsection 74(1) of the OSA stating that the distribution of securities by the Public Social Club is not subject to section 25 (registration requirements) and/or section 53 (prospectus requirements) of the OSA. *Re Midland Golf and Country Club Ltd.*²⁵, *Re Cedar Ridge Recreational Club*²⁶ and *Re Guelph Curling Club Ltd*²⁷, are examples of Commission decisions in which this route was opted for.

3. Other Compliance Requirements Under the OSA

If a Public Social Club is required to file a prospectus, then the Club would become a reporting issuer pursuant to the OSA and would also be subject to the OSA's continuous disclosure rules, as well as insider trading rules under the OSA.

a) Reporting issuer

In order to trade outside a closed system, investors must be provided with adequate information which a corporation usually provides by issuing a prospectus. A reporting issuer is defined in section 1 of the OSA and is distinct from an issuer in that it has issued securities under a prospectus or has its securities listed for trading on a stock exchange.²⁸ To support secondary trading of these securities, the reporting issuer must continuously disclose information on the securities as well as comply with the insider

²⁵ (2000), 23 OSCB 2351 and (1999), 22 OSCB 3678.

²⁶ (1997), 20 OSCB 4238.

²⁷ (2000), 23 OSCB. 1165.

²⁸ OSA, *supra*, note 4, subsections 1(b) and (c).

trading rules. Issuers who have not filed a prospectus will not be considered to be a reporting issuers and will not have this obligation. If a Public Social Club is required to file a prospectus and become a reporting issuer, other obligations would be imposed upon the Public Social Club, such as the timely disclosure requirements and the insider reporting obligations.

b) Periodic disclosure requirements

One of the most significant disclosure requirements to which reporting issuers are subject under Ontario securities law is that they are required to prepare, file and deliver certain financial statements for each completed financial year and each completed financial quarter.

c) Insider reporting obligations

Separate and apart from the insider trading requirements under the OCA, there are independent insider reporting requirements under the OSA. Section 1(1) of the OSA defines “insider of a reporting issuer” to include, *inter alia*, directors, senior officers, and persons or companies who beneficially own or control, directly or indirectly, voting securities of a reporting issuer. Insiders are required to comply with continuous reporting requirements with the Commission, disclosing any direct or indirect beneficial ownership of or control or direction over securities of the reporting issuer as may be required by the regulations.

4. Sanctions Under the OSA for Non-Compliance

Under the OSA, there are penal, administrative and civil sanctions for compliance breaches, for example, failing to file a prospectus where required. Subsection 122 (1) of the OSA creates a number of specific securities law offences. Two of these offences relate to including false, misleading, or incomplete information in various disclosure documents or in submissions to securities regulators. The third is a general offence committed whenever a person or company

contravenes Ontario securities law. In each case, on conviction, the guilty party is normally liable to a maximum fine of \$5 million, or a term of imprisonment of two years, or both.

The Commission has broad discretionary powers under section 127 of the OSA to make various orders “in the public interest.” Orders under section 127 may provide, *inter alia*, cessation of all trading in a specific security, removal of exemptions otherwise provided for by securities law, a review of market participant’s practices, and/or reprimand of a person or company. In deciding on the appropriate nature and duration of the sanction, the Commission has looked to the seriousness of the allegations proved, the respondents experience and level of activity in the market place, similar past conduct and the aim to deter similar abuses.²⁹

D. ISSUES UNDER THE INCOME TAX ACT AND CORPORATIONS TAX ACT (ONTARIO)

1. The Importance of Maintaining NPO Status

As long as a Public Social Club claims tax-exempt status as an NPO under paragraph 149(1)(l) of the ITA, as well as under paragraph 57(1)(b) of the CTA, all its income is exempt from income tax, save and except income from property that would qualify under subsection 149(5) of the ITA. It is critical that Public Social Clubs satisfy all necessary conditions in order to maintain their tax-exempt status. Otherwise, there are serious tax consequences of losing tax-exempt status.

Since the definition of an NPO under the ITA and the CTA are different, and the implications of these differences are important, the requirements and implications under both acts are explained separately below.

²⁹ See *Belteco Holdings Inc.* (1998), 21 OSCB 7743, referred to by the court in *Re Cartaway Resources Corp.* (2001), 10 ASCB 796.

2. Status of Public Social Clubs as NPOs Under the ITA

a) Legislative requirements under the ITA

In order for a Public Social Club to qualify as an NPO under the ITA, there are four criteria that the Public Social Club must satisfy under paragraph 149(1)(l) of the ITA, which provides as follows:

149(1) No tax is payable under this Part on the taxable income of a person for a period when that person was”:

...

(l) “non-profit organizations – a club, society or association that, in the opinion of the Minister, was not a charity within the meaning assigned by subsection 149.1(1) and that was organized and operated exclusively for social welfare, civic improvement, pleasure or recreation or for any other purpose except profit, no part of the income of which was payable to, or was otherwise available for the personal benefit of, any proprietor, member or shareholder thereof unless the proprietor, member or shareholder thereof was a club, society or association the primary purpose and function of which was the promotion of amateur athletics in Canada.”

These criteria are explained in detail in paragraph 1 of Interpretation Bulletin IT-496R, dated August 2, 2001, published by Canada Revenue Agency (formerly Canada Customs and Revenue Agency”) (“CRA”) and summarized below for ease of reference as follows:

- (a) It is not a charity;
- (b) It is organized exclusively for social welfare, civic improvement, pleasure, recreation or any other purpose except profit;
- (c) It is in fact operated exclusively for the same purpose for which it was organized or for any of the other purposes mentioned in (b); and
- (d) It does not distribute or otherwise make available for the personal benefit of a member any of its income unless the member is an association which has as its primary purpose and function the promotion of amateur athletics in Canada.

Paragraph 1 of Interpretation Bulletin IT-496R indicates that whether a particular association meets all of these criteria is “a question of fact that can only be determined after” reviewing the “purposes and activities of the association.”

b) Consequences of losing NPO status under the ITA

In the event that a Public Social Club loses its NPO status because the criteria set out in paragraph 149(1)(l) are not satisfied, the following consequences will result:

- The Public Social Club will lose its NPO status as of the time of the contravention and become a taxable entity under Part I of the ITA, as of that date pursuant to subsection 149(10) of the ITA.
- The Public Social Club will be deemed to have a taxation year ending at the time the Public Social Club loses its exempt status and a new taxation year beginning at the same time.
- The Public Social Club will be deemed to have disposed of all its property at fair market value at the time immediately before the exempt status is lost, and to have re-acquired all property at fair market value at that time.

c) Public Social Clubs as NPOs under the ITA

In addition to the above four criteria under the ITA referred to above, it is also important to examine the issue of whether the organizational form of Public Social Clubs as a public share capital corporations has any impact on the status of Public Social Clubs as NPOs.

In this regard, each of the statutory criteria to be an NPO is described below:

- i) The Public Social Club must not be a charity

The ITA requires that an NPO must not be a charity within the meaning of subsection 149.1(1) of the ITA. Paragraph 4 of Interpretation Bulletin IT-496R indicates that for purposes of this section, “an association may be considered to be a charity even if it is not a registered charity or if its designation as a registered charity has been revoked under section 168” of the ITA. This means that (1) the association must not be a registered charity with CRA and (2) it must not be a charity at common law even though it may not be registered with CRA as a registered charity. Being a charity at common law means an organization is established under one or more of the four heads of recognized charitable purposes at common law, namely relief of poverty, advancement of religion, advancement of education, or purposes that benefit the community as a whole.

- ii) The Public Social Club must be organized exclusively for certain purposes

The ITA requires that an NPO be organized exclusively for “social welfare, civic improvement, pleasure or recreation or for any other purpose except profit”. When determining the purposes for which an association is organized, paragraph 5 of Interpretation Bulletin IT-496R offers the following criteria:

When determining the purposes for which an association was organized, the instruments creating the association will normally be reviewed. These instruments may include letters patent, articles of incorporation, memoranda of agreement, by-laws, and so on. . . .

The ITA does not define the terms, “social welfare”, “civic improvement”, and “pleasure or recreation” but Interpretation Bulletin IT-496R defines them as follows:

In general terms, social welfare means that which provides assistance for disadvantaged groups or for the common good and general welfare of the people of the community.

Civic improvement includes the enhancement in value or quality of community or civic life. An example would be an association that works for the advancement of a community by encouraging the establishment of new industries, parks, museums, etc. Under the categories of social welfare and civic improvement, care must be taken to ensure that the purposes of the association are not those of a charity.

Pleasure or recreation means that which provides a state of gratification or a means of refreshment or diversion. Examples include social clubs, golf clubs, curling clubs, badminton clubs and so on that are organized and operated to provide recreational facilities for the enjoyment of members and their families.

The phrase any other purpose except profit is interpreted as a catch-all for other associations that are organized and operated for other than commercial or financial reasons.

Although it is preferable for the constating documents of Public Social Clubs to explicitly state that the Public Social Club is to carry on its operations without the purpose of profit, there does not appear to be, strictly speaking, a legal requirement to do so. Firstly, the above-noted excerpt from paragraph 5 of Interpretation Bulletin IT-496R indicates that the constating documents are to be reviewed when determining whether the organization in question is established for non-profit purposes. It does not require an express statement in this regard. Secondly, subsection 126(1) of the OCA, requiring the insertion of a non-profit clause, is only applicable to non-share capital corporations, not share capital corporations. Subsection 126(1) of the OCA states as follows”

A corporation, except [insurance corporations], shall be carried on without the purpose of gain for its members and any profits or other accretions to the corporation shall be used in promoting its objects and the letters patent shall so provide, and, where a company is converted into a corporation, the supplementary letters patent shall so provide.

- iii) The Public Social Club must be operated exclusively for the same purpose for which it was organized

The ITA requires that not only must an NPO be “organized exclusively” for “social welfare, civic improvement, pleasure or recreation or for any other purpose except profit”, it must also be “operated exclusively” for the purposes the NPO is organized. In *L.I.U.N.A. Local 527 Members Training Trust Fund v. Her Majesty the Queen [L.I.U.N.A.]*³⁰, in deciding whether the trust was operated exclusively for its purpose, Justice Bowman stated that in the purpose and spirit of the paragraph, both the original stated purpose and the manner in which the fund was operated must be considered for each year for which it seeks exemption under paragraph 149(1)(l). He goes on to say that this determination must be based on the facts of each case which can only be done by reviewing all its activities for that year.

This is in keeping with CRA’s Technical Interpretation 9306405, which also indicates that such a determination is a question of fact. Particularly, it states as follows:

A determination of whether an entity was operated exclusively for, and in, accordance with its non-profit purposes in a particular taxation year is based on the facts of each case. This information can be obtained only by reviewing, during the course of an audit, all of its activities for the year.

In this regard, there are three issues that arise in light of the comments contained in Interpretation Bulletin IT-496R, namely:

- ♦ Carrying on a trade or business;
- ♦ Excess accumulation of income; and
- ♦ Access of facilities of Public Social Clubs to non-members.

Each of the above issues is described below.

³⁰ 92 D.T.C. 2365.

(1) Carrying on a trade or business

One of the criteria suggested by Interpretation Bulletin IT-496R when determining if an association is operated exclusively for non-profit purposes is whether the association is carrying on a trade or business. In this regard, paragraph 7 of Interpretation Bulletin IT-496R provides as follows:

It will be a question of fact to be determined with regard to the particular circumstances as to whether an association is carrying on a trade or business and if so, whether it will result in finding that an association is not operated exclusively for non-profit purposes. Some characteristics that might indicate that an activity is a trade or business are as follows:

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

Generally, the carrying on a trade or business directly attributable to, or connected with, pursuing the non-profit goals and activities of an association will not cause it to be considered to be operated for profit purposes.

Technical Interpretation 9704605 makes it clear that “the income generating activity cannot be the principal activity of the corporation and must be carried on, and the resulting income must be used, by the corporation in carrying out its exempt objectives.” CRA explained in Technical Interpretation 2002-0153887 that “an organization may carry on income generating activity provided that there is a causal relationship between the profit making activity and the exempt purpose of the organization.”

The court in *Gull Bay Development Corporation v. Her Majesty the Queen*³¹ held that although the corporation in question was incorporated to promote the economic and social welfare of persons of native origin, it was permissible for that corporation to engage in a logging operation on an Indian reserve and use the profits from the logging operations in social welfare activities carried on by the corporation.

In *L.I.U.N.A.*³², the court held as follows:

For an organization to be operated for the purpose of earning a profit so as to disqualify it for the exemption under paragraph 149(1)(l), it would be necessary that it do more than merely earn passive investment income. The earning of such income would need to be both an operating motivation of the fund and a focus of its activity.

In that case, the court held that the “earning of interest income was not the purpose – primary or secondary - for which the fund was operated.” The court continued to hold that “[t]he earning of interest was simply an incident of the only purpose for which the fund was operated, the training of the members of the union; it was a means to an end and not an end in itself.” In determining what is the primary purpose of an organization, CRA clarified in Technical Interpretation 2002-0119895 as follows:

This question would be a question of fact, as well as whether or not this is the society’s main purpose. Since there is no definition of main purpose in the Income Tax Act, its determination in any particular case is a question of fact. The dictionary meaning seems to be synonymous with “chief in size or extent” or perhaps of “pre-eminent importance” or “primary”. The Agency considers that the “used primarily” test will be met where more than 50% of the assets in question are used in whatever process is involved. This suggests that the main purpose test for a club would be met where more

³¹ 84 DTC 6040 (F.C.T.D.).

³² *L.I.U.N.A.*, *supra*, note 30.

than 50% of the assets of the club are utilized to provide dining, recreational or sporting facilities for its members.

It can be inferred from the above that if an activity can be characterized as a passive investment of a Public Social Club's resources, it is not necessarily a "purpose" or operating motivation of the Public Social Club. Paragraph 7 of Interpretation Bulletin IT-496R recognizes that "the carrying on a trade or business directly attributable to, or connected with, pursuing the non-profit goals and activities of an association will not cause it to be considered to be operated for profit purposes".

(2) Excess accumulation of income

Another criteria suggested by Interpretation Bulletin IT-496R when determining if an association is operated exclusively for non-profit purposes is whether the association has accumulated excess funds each year that is beyond the association's reasonable needs to carry on its non-profit activities. In this regard, paragraphs 8 and 9 of Interpretation Bulletin IT-496R provides as follows:

An association may earn income in excess of its expenditures provided the requirements of the Act are met. The excess may result from the activity for which it was organized or from some other activity. However, if a material part of the excess is accumulated each year and the balance of accumulated excess at any time is greater than the association's reasonable needs to carry on its non-profit activities, profit will be considered to be one of the purposes for which the association was operated. This will be particularly so where assets representing the accumulated excess are used for purposes unrelated to its objects, such as the following:

- (a) long-term investments to produce property income;
- (b) enlarging or expanding facilities used for normal commercial operations, or
- (c) loans to members, shareholders or non-exempt persons.

The amount of accumulated excess income considered reasonable in relation to the needs of an association to carry on its non-profit activities and goals is a question of fact to be determined with regard to the associations' particular circumstances . . . Where the present balance of accumulated excess is considered excessive or an annual excess is regularly accumulated that is greater than an association's needs to carry on its non-profit activities, it may indicate that the association's aims are two-fold: to earn profits and to carry out its non-profit purposes. In such a case, the operated exclusively requirement in paragraph 149(1)(l) would not be met.

Technical Interpretation 2002-0180335 indicates that “[t]he earning of investment income should not, in and by itself, deny an organization NPO status as long as all funds, including any investment income earned, are ultimately used in achieving the corporation’s non-profit objective.” It continues to states that “[h]owever, should income accumulate to create a surplus fund beyond that needed to carry on the corporation’s non-profit activities, profit will be considered to be one of the purposes for which the corporation was operated.” Technical Interpretation 9306405 further explains to what extent an accumulated excess of funds would be considered reasonable by CRA as follows:

The amount of accumulated excess considered reasonable in relation to the needs of a club to carry on its non-profit activities is dependent on such things as the amount and pattern of receipts from various sources such as membership fees, training course fees, exam fees and so on. It is conceivable that there would be situations where an accumulation equal to one year’s reasonably anticipated expenditure on its non-profit activities may not be considered excessive while in another situation an accumulation equal to two months’ reasonably anticipated expenditures would be considered more than adequate. For example, a year-end accumulation equal to the following year’s expenditures would probably be considered reasonable where a club carries out its “annual fund drive” in the last month of its fiscal period in anticipation of its non-profit activities planned for the following year. However, where another club raises its funds on regular

basis throughout the year, it may be difficult to justify a year-end accumulation in excess of an amount equal to its expenditures for one or two months.

Various CRA Technical Interpretations (including 9214695, 9307285, and 9306405) also indicate that it is the position of CRA that funds may be accumulated in “exceptional circumstances where a special project requires a time period in excess of the current and prior year to accumulate the necessary funds.” Under those situations, CRA requires that the organization should maintain two bank accounts for the project, which capital collected deposited in one bank account, and income earned by the organization deposited into another bank account.

(3) Access of facilities of Public Social Clubs to non-members

In a letter from CRA to a non-profit club dated October 23, 1991³³, CRA indicated that the use of the facilities of a non-profit club by the public may disqualify the club as an NPO. In this regard, CRA states in the letter:

Generally, where the facilities of an organization are available to non-members and used by them to a significant degree with the result that

(a) activities carried on for the members are subsidized by the profits earned from non-members because the fees or assessments charged to the members are either well below cost or nil

or

(b) profits [from] non-members are used to acquire and maintain facilities or other properties which the members use for no charge or for a fee well below cost,

the income of the organization would be considered payable to or available for the benefit of members and as a result the non-profit club would no longer qualify under paragraph 149(1)(l) of the Income Tax Act (the ‘Act’) and cease to qualify for the income tax

³³ Document number OC91_077.79.

exemption for that year. Accordingly, the income earned by the club in that year would be taxable.

Then, CRA continued to explain the meaning of bona fide guests as follows:

This would not be the case where the facilities are used by bona fide guests of members. A person would be considered to be a bona fide guest of a member if the guest was a spouse, parent or child of the member. Other bona fide guests or members include individuals where the member is required to be present with his guest, and there are reasonable restrictions on the number of guests a member may have at one time and on the number of times a person can be invited to participate in the organization's activities as guests of a member.

CRA indicated that failure to satisfy this requirement would cause the organization to be disqualified for tax exemption as NPOs for failing to operate exclusive for non-profit purposes. CRA stated as follows:

In our view, where a non-profit club receives income from bona fide guests such income would form part of the total income of the club and provided that the club otherwise maintain its non-profit objects and operates exclusively for pleasure or recreation or for any other purpose except profit, the income would not be taxable. The use of the word "exclusively" from a strict technical view means 100%.

. . . Accordingly, in our view, provided the profits earned from the guests fees serve solely to contribute to the club's objectives, provided of course that the regular members do not pay fees well below costs, the income from the guest fees would not, in and by themselves, disqualify the club from claiming the tax exemption. Although, it would be a question of fact, if the profits earned from the non-members are excessive, in our view, the club would not be operating "exclusively" towards its non-profit objectives.

As such, where possible, access to Public Social Clubs should be restricted to members and their guests instead of allowing the public to use the facilities of Public Social Clubs.

- iv) No part of the income of the Public Social Club was “payable to, or was otherwise available for the personal benefit of” any shareholder of the Public Social Club

The ITA requires that no part of its income be made available to the members or shareholders of an NPO. In this regard, paragraph 11 of Interpretation Bulletin IT-496R provides as follows:

An association may fail to comply with this requirement in a variety of ways. For example . . . an association would not qualify as tax-exempt if

- (a) *it distributed income during the year, either directly or indirectly, to, or for the personal benefit of any member, or*
- (b) *it has the power at any time to declare and pay dividends out of income.*

An association that has been tax-exempt may fail to comply with this requirement on a winding up, dissolution or amalgamation. For example, on winding-up, such an association will lose its tax-exempt status at the time when a determination is made that an amount of income will become payable to, or otherwise available for the benefit of, a member other than a member [of a registered Canadian amateur athletic association.] Possible difficulties in this regard may be avoided if the association’s enabling documents provide that upon a winding-up, amalgamation or dissolution all of its assets and accumulated income are to be transferred to an organization with similar objects that qualifies for exemption under paragraph 149(1)(l). [Emphasis added]

In this regard, Technical Interpretation 9306045 indicates as follows:

A club may fail to comply with this requirement in a variety of ways. Some of these are as follows:

- the club distributed income during the year, either directly or indirectly, to or for the personal benefit of any member;
- the club has the power at any time in the current or future years to declare and pay dividends out of income; or
- the club in the case of a winding-up, dissolution or amalgamation has the power to distribute income to a member.

Although the payment of income to members or shareholders of an NPO upon dissolution is prohibited under the ITA, the return of capital to the members or shareholders is not. Also, subsection 149(2) of the ITA also operates to allow an NPO to distribute its net capital gains to members or shareholders. How this is done depends upon, for example, the nature and types of shares issued by the Public Social Club in question and whether the Public Social Club's constating document has any provision regulating the distribution of the assets of the Public Social Club on dissolution.

Upon dissolution of Public Social Clubs, all property of the Public Social Clubs would need to be distributed rateably among its shareholders in accordance with paragraph 319(1)(b) of the OCA. In particular, paragraph 319(1)(b) of the OCA provides as follows:

319(1) The charter of a corporation incorporated by letters patent may be surrendered if the corporation proves to the satisfaction of the Lieutenant Governor,

- (a) that the surrender of the charter has been authorized . . . ,
- (b) that it has parted with its property by distributing it rateably among its shareholders or members according to their rights and interests in the corporation . . .

The inherent right of the shareholders to share in the assets of Public Social Clubs is similar to a situation referred to Technical Interpretation 2002-0180335 in which CRA was asked whether a provision in the letters patent of a corporation (Newco) that allows distribution of assets of Newco to its members on dissolution prevent Newco from qualifying as an NPO until such dissolution occurs. CRA responded as follows:

You state that . . . Newco's letters patent allows for distribution of Newco's assets on dissolution to one or more organizations *which may include members of Newco*. We confirm that the provision in the letters patent, in and by itself, will not affect Newco's status as an NPO under paragraph 149(1)(l) of the Act. However,

if Newco qualifies as an NPO, it should be noted that *as soon as the Board of Directors of Newco passes a resolution authorizing the dissolution of Newco, and a member of Newco becomes entitled to receive property from Newco, Newco will lose its NPO status and will become subject to tax.* [Emphasis added]

As such, it would appear that the right of the shareholders to share in the assets of a Public Social Club on dissolution would not have the effect on the Public Social Club being disqualified as NPOs. However, as soon as the Public Social Club passes a resolution to dissolve the Public Social Club and a determination is made to distribute its assets to its shareholders, the NPO status of the Public Social Club would be lost at that time.

This was demonstrated by the decision of the Tax Appeal Board in *Moose Jaw Industrialization Fund Committee Ltd. v. Minister of National Revenue*.³⁴ In that case, the Tax Appeal Board considered whether the possibility that property might be received by the shareholders of a society upon its winding up would disqualify the society as an exempt entity from the outset or only upon the winding up of the society in relation to subsection 4(h) of the *Income War Tax Act*, a predecessor provision to paragraph 149(1)(l) of the ITA. The Board adopted a “wait and see” approach and held that the problem of what would happen to surplus on winding up was not to be contemplated in determining whether a company was an NPO. In this regard, the Board held as follows:

To accept the contention of the [Minister], I would have to take for granted that the appellant company is eventually going to be wound up and that, at that time, some undistributed income will be available for distribution. I do not think that such an eventuality is to be contemplated in giving an interpretation to paragraph (h) of Section 4 of the Act. I believe that to delve into the realm of the possibilities and eventualities is to go too far, for if one can agree that upon the winding up of the company some of its income may inure to the benefit of its stockholders, it could just as well be

³⁴ (1951) 5 Tax A.B.C. 32.

argued that no amount from accumulated income will then be available for distribution.

The adoption of this “wait and see” approach by the court in *L.I.U.N.A.*³⁵ led to the CRA’s amendment of Interpretation Bulletin IT-496. As a result of the amendment, the following commentary is contained in paragraph 11 of Interpretation Bulletin IT-496R, which states as follows:

An association that has been tax-exempt may fail to comply with this requirement on a winding up, dissolution or amalgamation. For example, on winding-up, such an association will lose its tax-exempt status *at the time when a determination is made that an amount of income will become payable to, or otherwise available for the benefit of, a member other than a member described in paragraph 13.* [Emphasis added]

Although Interpretation Bulletin IT-409 concerning the winding-up of an NPO has recently been archived by CRA as of January 23, 2003, the following excerpt appears to continue to be the current position of CRA:

Paragraph 149(1)(l) provides in part that no part of the income of a non-profit organization shall be payable to or otherwise available for the personal benefit of any proprietor, member or shareholder thereof unless the proprietor, member or shareholder was a club, society or association, the primary purpose and function of which was the promotion of amateur athletics in Canada. *The Department views a corporation as having lost its status as a non-profit organization at the time when a determination is made that, upon winding-up, an amount of income shall become payable to or otherwise available for the benefit of a proprietor, member or shareholder other than those that are excepted.* [Emphasis added]

³⁵ *L.I.U.N.A.*, *supra*, note 30.

3. Status of Public Social Club as NPOs Under the CTA

a) Legislative requirements under the CTA

The definition of an NPO under the CTA is materially different in some respects from the definition of an NPO under paragraph 149(1)(l) of the ITA. Paragraph 57(1)(b) of the CTA provides as follows:

57(1) Except as hereinafter provided, no tax is payable under this Part upon the taxable income of a corporation for a period when that corporation was”:

...

(b) “non-profit organizations – a club, society or association that, in the opinion of the Minister, was not a charity within the meaning given to that expression by subsection 149.1(1) of the Income Tax Act (Canada) and that was organized and operated exclusively for social welfare, civic improvement, pleasure or recreation or for any other purpose except profit, which *has not in the taxation year or in any previous taxation year* distributed any part of its income to any proprietor, member or shareholder thereof, *or appropriated any of its funds or property in any manner whatever to or for the benefit of any proprietor, member or shareholder thereof*, unless the proprietor, member or shareholder was a club, society or association, the primary purpose and function of which was the promotion of amateur athletics in Canada.” [Emphasis added]

b) Consequences of losing NPO status under the CTA

Subsection 57(2) of the CTA goes on to set out the consequences if the organization in question contravenes the requirements for an NPO as set out in paragraph 57(1)(b) of the CTA.

Similar to paragraph 149(1)(l) of the ITA, subsection 57(2)(a) provides that if any part of the income of the organization is distributed to the members or shareholders of the organization, or if any of its funds or property has been appropriated for the benefit of the members or shareholders of the organization, then the organization would become taxable in respect of its income for the year in which it loses its NPO status, as well as for all future income. What is different from paragraph 149(1)(l) of the ITA is that, more

seriously, subsection 57(2)(a) also provides that all income from all previous years for which the organization qualified for as an NPO would also be deemed to be income in the current taxation year and subject to tax in the year in which it loses its NPO status and hence prior year income becomes currently and retroactively taxable.

However, paragraph 57(2)(b) of the CTA appears to provide a relief for the prohibition against the distribution of income and appropriation of property for benefit of members or shareholders of an NPO upon dissolution of the NPO. Specifically, paragraph 57(2)(b)(i) of the CTA provides that on dissolution of an NPO, it is permissible to return to members or shareholders amounts paid on account of capital. As well, paragraph 57(2)(b)(ii) also permits payment to members and shareholders of the NPO “that part of the corporation’s surplus that is attributable to income that was exempt under this section other than taxable capital gains”.

Although the return of capital to members and shareholders upon dissolution of an NPO is also permissible under the ITA, the distribution of income of an NPO upon its dissolution is not permissible under the ITA. In other words, upon the dissolution of an NPO, if the NPO was to distribute any of its income to its shareholders, this would lead to the NPO losing its NPO status under the ITA at the time of dissolution and would lead to adverse tax consequences under paragraph 149(10) of the ITA. However, such distribution of income upon dissolution would not cause the NPO to lose its NPO status under the CTA pursuant to paragraph 57(2)(b) of the CTA. It is unclear why there is a difference in the two taxing statutes. Perhaps the answer is that the prohibition in the ITA refers to current income rather than the previous years’ undistributed income. Unfortunately, there has not been any documentation or case law on point that would explain this difference.

c) Issues of concern to the status of Public Social Clubs as NPOs under the CTA

Due to the consequences in tax liability in the event that a Public Social Club loses its NPO status under the CTA, it is important to ensure that the Public Social Club is able to

satisfy all the requirements to qualify as an NPO under the CTA and is able to maintain this status.

The criteria that a Public Social Club is required to satisfy in order to successfully claim and maintain its status as an NPO under paragraph 57(1)(b) of the CTA are very similar to the criteria set out in paragraph 149(1)(l) of the ITA. The criteria set out in paragraph 57(1)(b) of the CTA are as follows:

- The Public Social Club must not be a charity;
- The Public Social Club must be organized exclusively for “social welfare, civic improvement, pleasure or recreation or for any other purpose except profit”;
- The Public Social Club must be operated exclusively for the same purpose for which it was organized; and
- The Public Social Club must not have “in the taxation year or in any previous taxation year” (1) distributed any of its income to any shareholder of the Public Social Club, or (2) appropriated any of its funds or property in any manner to or for the benefit of any shareholder of the Public Social Club.

The first three criteria are the same as those contained in paragraph 149(1)(l) of the ITA. The last criteria, however, is different from the criteria under the ITA. Under the ITA, no part of the income of a Public Social Club can be “payable to, or was otherwise available for the personal benefit of” any shareholder of the Public Social Club. However, under the CTA, not only is the Public Social Club not permitted to distribute its income to its shareholders, the funds or the property of the Public Social Club must not be “appropriated . . . to or for the benefit of any shareholder of the Public Social Club.”

E. ISSUES INVOLVING SHAREHOLDERS

Public Social Clubs need to be aware that shareholders have rights that are separate from the rights that they may have as members of Public Social Clubs. In other words, the rights of shareholders are distinct from the rights of members of Public Social Clubs. Some of the issues that may arise as a result of the different rights in this regard are set out below as follows:

1. Equity of the Shares Held by Shareholders

The question regarding whether the shares of a Public Social Club carry any equity value is a question of fact based upon the understanding of the shareholders when they purchased their shares from the Public Social Club. Most social clubs operate on a membership basis. As explained earlier, this means that a primary reason for adopting a share capital corporate structure may very well have been to raise funds for capital and operational needs of the club. These Public Social Clubs, though, may never have intended that their shareholders would share in the assets of the Public Social Clubs in the future, including a distribution of shareholder equity upon dissolution.

2. Issues Regarding Non-Member Shareholders

As explained earlier, it is possible for Public Social Clubs to include provisions in their letters patent to impose restrictions on the right to transfer the shares of Public Social Clubs or to prohibit an invitation to the public to subscribe for shares in Public Social Clubs. For those Public Social Clubs whose letters patent do not include these provisions, their shares could in theory be bought and sold in the open market and an invitation could be extended to the public to subscribe for their shares. This would in turn mean that they would not have the ability to prevent non-members from holding shares of the Public Social Club. This might happen where a member of a Public Social Club purchased shares from the Club and later did not maintain their membership status in the Public Social Club but retained ownership of his/her shares. In that event, the following are some of the issues that may arise:

a) Method of providing notice of shareholders' meetings

Paragraph 93(1)(a) of the OCA requires that notice of shareholders' meetings, "in the absence of other provisions in the by-laws of the company", "shall, unless all the shareholders entitled to notice of the meeting have waived in writing the notice, be given by sending it to each shareholder entitled to notice of the meeting by prepaid mail ten days or more before the date of the meeting to the shareholder's last address as shown on the books of the company". The documents that are also required to be sent to the shareholders' last address as shown on the books of the company in accordance with the statutory requirements of the OCA, together with the notice of meeting, include proxy forms pursuant to subsection 85(1), information circular pursuant to paragraph 86(1)(a), financial statements of the Public Social Club and the auditor's report pursuant to subsection 109(1), and interim financial statements within 6 months of the year end for the Public Social Club pursuant to section 110.

Accordingly, it is important that Public Social Clubs exercises reasonable due diligence in maintaining up-to-date register of shareholders and their address of service. This may become an issue when non-member shareholders are not current members of a Public Social Club due to various reasons. For example, some of them may have been deceased, while others may have moved without providing the Public Social Club with their current forwarding address.

b) Quorum requirements at shareholders' meetings

Subsection 68(1) of the OCA gives the directors powers to pass by-laws stipulating the quorum for meetings of shareholders. In exercising this right, Social Clubs should give due consideration to choosing the appropriate quorum, being mindful that active membership may decrease over time and therefore setting, for example, a high quorum may later serve to frustrate their efforts to conduct a meeting. This may become an issue as non-member shareholder increase over time who may not attend shareholders meeting for various reasons, such as a lack of interest in the operation and management of the

Club or do not receive notice of shareholders' meeting as a result of them not having notified the Public Social Clubs of their change of address for service.

c) Resolution adoption requirements

Subsection 68(1)(f) of the OCA provides that directors have the power to pass by-laws concerning "the procedure in all things at shareholders' meetings." Public Social Clubs therefore may enact by-laws that specify what percentage of votes is required to settle questions that arise at shareholders' meetings. If the by-law of a Public Social Club is drafted such that a high level of approval from the shareholders is required for certain matters, this may affect the ability of the Public Social Club to pass certain resolutions, especially if the number of non-member shareholders increases over time. This may be avoided if by-laws of Public Social Clubs provide that a certain level of approval is required from the votes casts by shareholders at a meeting of shareholders. In this case, the only concern for the Public Social Club is to ensure that the necessary quorum is attained to constitute the meetings.

d) Maintaining control by active member shareholders

Another issue to consider is to ensure that control of Public Social Clubs remain with shareholders who are active members of the Public Social Club. Otherwise, if a greater proportion of a Public Social Club's shares are held by inactive members or by non-members than by shareholders who are active members of the Public Social Club, it may be difficult for member shareholders to maintain majority control or ownership over the operation of the Public Social Club. This is may be achieved, for example, by inserting restrictions on the transfer of the shares of the Public Social Clubs so that only members are eligible to subscribe shares of the Public Social Clubs and/or by requiring the shareholders to agree in writing to sell their shares back to the Public Social Clubs if they are no longer active members.

F. CONVERSION INTO NON-SHARE CAPITAL CORPORATIONS

One of the ways to address and to avoid the various issues explained above is to convert the Public Social Club into a non-share capital corporation. There are two possible procedures to effect such a conversion under the OCA. The first is by way of the Public Social Club applying for supplementary letters patent to decrease the authorized capital of the Public Social Club by cancelling issued or unissued shares and to convert the Public Social Club into a non-share capital corporation under subsection 34(1) of the OCA. Alternatively, the Public Social Club may apply to court under section 112 of the OCA to obtain court sanction of a proposed “arrangement” between the Public Social Club and its shareholders. The former alternative would require that sufficient support be obtained from shareholders of the Public Social Club. The latter alternative may be utilized if it is unable to obtain the necessary approval from shareholders to authorize the application for supplementary letters patent to convert the Public Social Club into a non-share capital corporation.

Subsection 34(1) of the OCA permits a share capital corporation to apply for supplementary letters patent to decrease its authorized capital by cancelling issued or unissued shares and to convert the corporation into a non-share capital corporation. Subsections 34(1)(d) and (p) provide as follows:

34(1) A company may apply to the Lieutenant Governor for the issue of supplementary letters patent,

...

(d) decreasing,

(i) its authorized capital by cancelling issued or unissued shares with or without par value . . . , or

(ii) . . .

...

(p) converting it into a corporation without share capital . . .

The effect of such supplementary letters patent would allow the Public Social Club to decrease the capital of the Public Social Club by cancelling its shares, including the shares held by non-member shareholders, and to convert the Public Social Club into a non-share capital corporation. The Club

would also need to ensure that should a special resolution decreasing authorized capital and cancelling issued shares be passed, the solvency test set out in section 35 of the OCA would need to be met. Section 35 of the OCA states as follows:

On an application for supplementary letters patent decreasing authorized or issued capital, the company shall establish to the satisfaction of the Minister that after the decrease the company will be solvent and, if required by the Minister, shall establish to his or her satisfaction that there are no creditors who object to the application.

In this regard, it should be noted that according to section 37 of the OCA, shareholders on the date of grant of the supplementary letters patent that decreases issued capital are individually liable to creditors up to the amount they received in repayment. Therefore, if a Public Social Club is unable to pay creditors as a result of the decrease in authorized capital, an individual shareholder that owned shares and received consideration from the Public Social Club would be liable to creditors for up to that amount. This liability remains if the Public Social Club is sued within six months of the supplementary letters patent or if the individual is sued within two years of the supplementary letters patent. For ease of reference, section 37 is reproduced below;

(1) On a decrease of the issued capital of a company by supplementary letters patent, each person who was a shareholder on the date of the supplementary letters patent is individually liable to the creditors of the company for the debts due on that date to an amount not exceeding the amount of the repayment to the person or reduction of the person's liability, or both, as the case may be.

(2) A person is not liable under subsection (1),
(a) unless the company has been sued for the debt within six months after the date of the supplementary letters patent and execution has been returned unsatisfied in whole or in part; and
(b) unless the person is sued for the debt within two years from the date of the supplementary letters patent.

Subsection 34(2) of the OCA provides that such an application for supplementary letters patent must be authorized by a “special resolution” which is defined in section 1 of the OCA as follows:

“special resolution” means a resolution passed by the directors and confirmed with or without variation by at least two-thirds of the votes cast at a general meeting of the shareholders or members of

the corporation duly called for that purpose, or, in lieu of such confirmation, by the consent in writing of all the shareholders or members entitled to vote at such meeting.

This option of converting into a non-share capital corporation has only recently become a possibility as a result of recent amendments made to the OCA in June 2001. Prior to the 2001 amendment of the OCA in 2001, such a conversion required the approval of either (a) the written consent of 100% of the shareholders or (b) a 95% vote of all of the shareholders, subject to the right of dissent by any shareholder after the vote has been taken. Accordingly, the supplementary letters patent must be approved by the board of directors of the Public Social Club, followed by a two-thirds majority vote by the shareholders ratifying the directors' resolution to authorize the supplementary letters patent.

Alternatively, an application may be made to the court under section 112 of the OCA either by the Public Social Club or by shareholders to obtain court sanction of a proposed "arrangement" between the Public Social Club and its shareholders. A court sanction in this regard would require the approval of a 75% vote of the shareholders of the Public Social Club, higher than the two-thirds approval required under subsection 34(2) of the OCA.

However, it must be noted that a conversion in this regard from a share capital structure to non-share capital structure may involve complicated tax liability and corporate re-organizational issues, such as the consequences involved in redemption and cancellation of the shares of the Public Social Club and a careful review of all related issues would need to be undertaken before taking steps to effect or implement the conversion.

G. CONCLUSION

Although the public share capital structure of a Public Social Club may facilitate the short term raising of capital required by the Public Social Club beyond what can be obtained through membership initiation fees or debt financing, there are a number of significant consequential issues that should be carefully considered as outlined in this paper. Whether or not a Public Social Club should remain as a public share capital corporation or convert into a non-share capital corporation is also an important issue that legal counsel for the Public Social Club will want to consider as part of his/her due diligence role in advising the client.