THE ONTARIO BAR ASSOCIATION

Apples, Oranges or Lemons? Legal Issues Arising in the Form, Function and Fundraising of Charitable and Not-for Profit Organizations
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Share Capital Social Clubs as NPOs: Issues to Consider

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Introduction
There are many social clubs in Ontario, e.g. country clubs, golf clubs, tennis clubs, flying clubs, curling clubs, bowling clubs, etc.

• Over 400 social clubs in Ontario are share capital corporations under either Corporations Act (Ontario) or federal statutes

• Over half of the 400 share capital social clubs in Ontario are organized under the Corporations Act (Ontario)

• Organizing as share capital corporation is an alternate means of fundraising other than charging initiation fees and/or debt financing

• Many of these social clubs are public share capital corporations and operate as non-profit organizations (NPOs) under the Income Tax Act and the Corporations Tax Act (Ontario)

• “Public Social Clubs” in this presentation refers to social clubs that are:
  – public share capital corporations under the Corporations Act (Ontario)
  – operate as NPOs
Issues that arise for Public Social Clubs include

- Issues under the Corporations Act (Ontario)
- Issues under the Securities Act (Ontario)
- Issues under the Income Tax Act
- Issue under the Corporations Tax Act (Ontario)
- Issues involving shareholders

Issues under the Corporations Act (Ontario)

- S. 2(2)(a) of the Business Corporations Act (Ontario) provides that the Act does not apply to corporations under the OCA that has objects in whole or in part of a social nature
- Cannot incorporate share capital social clubs under the Corporations Act (Ontario) since 1971 when the OBCA was first enacted
Nature of Public Social Clubs under the
*Corporations Act* (Ontario)

- public corporations are those corporations that are not private corporations
- private corporations must meet all of the following criteria
  - restriction on the right to transfer shares
  - fifty or less shareholders
  - no invitation to the public to subscribe for shares or securities in the corporation

Obligations of Public Social Clubs under the
*Corporations Act* (Ontario)

- Detailed auditing requirements
  - More detailed audit requirements than those required for private companies
  - For example:
    - need to include a statement of profit and loss for each period that includes a statement of “sales or gross operating revenue”
    - need to prepare a statement of source and application of funds for each period
    - need to prepare and forward to the shareholders interim financial statements for each six-month period
• Insider trading reporting requirements
  – S. 72(1) of the OCA provides that an “insider” is anyone who is a director or senior officer of a public corporation that has 15 or more shareholders
  – S. 72(1) of the OCA provides on-going reporting requirements on an insider to file a report with the Ontario Securities Commission on the insider’s ownership of or control/direction over the capital securities of the corporation

– There are separate reporting requirements from the insider trading requirements under the Securities Act (Ontario)
  – Insider trading requirements should not apply because the public policy reason for insider trading rules is not present when dealing with a not-for-profit organization

• Detailed proxies and information circular disclosure requirements
  – Sections 83 to 90 of the OCA contain detailed requirements on what information would need to be included in the proxies, e.g.
    • certain information must be in bold-face type
• must provide a designated blank space for dating the proxy

• must provide means whereby the shareholder is afforded an opportunity to specify that his/her shares shall be voted by the proxy holder in favour of or against, in accordance with the shareholder’s choice, each matter identified in the proxy or in the information circular, other than the election of directors and the appointment of auditors

– Sections 30 and 31 of Regulation 181 of the OCA contain detailed requirements concerning the form and contents of information circular that must be provided to the shareholders each time a shareholders’ meeting is called, e.g.

  • the information circular must be in accordance with Form 16 of the Regulation 181

  • there are specific disclosure requirements concerning remuneration of directors and officers
• there are specific disclosure requirements concerning slate of candidates for election as directors

• there are specific disclosure requirements concerning equity shares held by directors

• a copy of the circular must be filed with the Ontario Securities Commission

Issues under the Securities Act (Ontario)

• The OSA has reporting and registration requirements for anyone who trades in securities unless exempted

• “Securities” is broadly defined under the OSA and shares of Public Social Clubs falls within the definition of “securities”
• “Trade” is also broadly defined under the OSA, including “any sale or disposition of a security for valuable consideration”

• If the issuance of shares of a Public Social Club is within this broad definition, then a Public Social Club would need to comply with the OSA unless it is otherwise exempted

Exemptions available under the Securities Act (Ontario) include

• S. 35 (1) of the OSA provides a list of “trades” that are exempt from the registration requirement

• S. 35(2) of the OSA provides a list of “securities” that are exempt from the registration requirement

• If either list applies, then the Public Social Club would be exempt from registration
Exemptions from registration requirements

- Paragraph 35(2)7 provides for an exemption if
  - The issuer is “organized exclusively for education, 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

- The issuer is “organized exclusively for education, benevolent, fraternal, charitable, religious or recreational purposes,”
  - The exempt purposes set out in paragraph 35(2)7 of OSA are different from what constitutes a not-for-profit organization under paragraph 149(1)(l) of the *Income Tax Act* for NPOs
  - Paragraph 149(1)(l) of the *Income Tax Act* requires NPOs be “organized exclusively for social welfare, civic improvement, pleasure, recreation or any other purposes except profit”
The issuer is not-for-profit
  – Organized not-for-profit vs. operated not-for-profit

No commission or other remuneration is paid in connection with the sale of securities of the issuer
  – No commission must be payable directly or indirectly upon the transfer of the shares
  – It is a question of fact whether a commission is payable in conjunction with the transfer of shares

Exemptions from prospectus requirements
  • If a Public Social Club is exempt from registration, then it would be exempt from prospectus requirement

Other requirements under the OSA
  • Reporting issuer
  • Periodic disclosure requirements
  • Insider reporting obligations
Issues under the *Income Tax Act*

- NPO status under paragraph 149(1)(l) of the *Income Tax Act* (ITA)
  - Must not be a charity
  - Must be “organized exclusively for social welfare, civic improvement, pleasure, recreation or any other purposes except profit”

- Must be operated for the same purposes as the purposes for which it was organized
- Must not distribute or make available income for the benefit of shareholders

Each of the above four criteria is explained in further detail below
Consequences of losing NPO status

- Will become a taxable entity on the date of contravention of the requirements under paragraph 149(1)(l)
- Will be deemed to have a taxation year beginning at that time
- Will be deemed to have disposed of all property at fair market value at that time

Must not be a charity

- Must not be a registered charity
- Must not be a charity at common law established under one or more of the four heads of recognized charitable purposes at common law, even though the entity may not be a registered charity
Must be organized exclusively for certain purposes

- Must be “organized exclusively for social welfare, civic improvement, pleasure, recreation or any other purposes except profit”
- A question of fact, depending on the constating document
- S. 126(1)of the OCA requiring the insertion of a non-profit clause is only applicable to non-share capital corporations

Must be operated exclusively for the same purposes for which they are organized

- A question of fact
- Whether the organization carry on a trade or business
- Whether there is any accumulation of income
- Whether the public has access to the facilities of the Public Social Club
Must not distribute or make available income for the benefit of shareholders

- For example
  - Cannot distribute income to the shareholders
  - Cannot have the power to declare and pay dividends out of income
  - Cannot distribute income to shareholders upon winding up or dissolution or amalgamation

- CRA and the court adopts a “wait and see” approach
  - The right of shareholders to share in the assets of Public Social Clubs on dissolution would not disqualify the Public Social Club as an NPO
  - But as soon as the Public Social Club passes a resolution to dissolve the club and a determination is made to distribute its assets to the shareholders, the NPOs status would be lost at that time

- May return capital or distribute net capital gains to the shareholders
Issues under the Corporations Tax Act

- Similar issues and criteria requirements as the ITA

- More serious consequences under the CTA upon the lost of NPO status – all income from all previous years for which the organization qualified as an NPO would also be deemed to be income in the current taxation year and subject to tax

Upon dissolution, may return capital to shareholders and may distribute that part of the corporation’s surplus that is attributable to income that was exempt under the CTA

- Must not allow property of the corporation be appropriated for the benefit of the shareholders
Issues involving shareholders

- Question of fact whether shareholders have any equity in Public Social Clubs
- Most Public Social Clubs operate on a membership basis which may not be consistent with equity status of shareholders
- Issues of concern
  - Providing notice to shareholders
    - Must provide notice of meeting, information circular and proxy forms etc. to all shareholders, whether or not they are active members of the Public Social Clubs
    - Important to exercise due diligence to maintain the shareholders register up-to-date
  - Meeting quorum requirements
    - If the bylaw of Public Social Clubs requires a high quorum requirement for shareholders’ meetings, this may become an issue as non-member shareholders increase over time
  - Obtaining approval for resolutions
    - If the bylaw of Public Social Clubs requires a high approval requirement for adoption of resolutions, this may become an issue as non-member shareholders increase over time
– Maintaining control by active member shareholders

- It is important for Public Social Clubs to ensure that control of the Public Social Clubs remain with active members of the clubs

- This may be achieved through different means, e.g. restricting the transfer of shares so that only members are eligible to purchase shares, requiring shareholders to agree in writing to sell their shares back to the club when they are no longer members of the Public Social Clubs

Conversion into non-share capital corporations

- Prior to 2001, the conversion of a Public Social Club into a non-share capital corporate required the approval of either (a) the written consent of 100% of the shareholders or (b) a 95% vote of all shareholders, subject to the right of dissent by any shareholder after the vote
• Application for supplementary letters patent under s. 34(1) of OCA
  – For the decease in the capital by canceling shares and to convert to a non-share capital corporation
  – Requires the approval of a special resolution

• Application for sanction of the court under s. 112 of the OCA

Conclusion

• There are important issues for legal counsel to discuss with their clients that are Public Social Clubs

• It is also important to review whether to convert into a non-share capital corporation under the Corporations Act (Ontario)
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