
**YORK SMALL BUSINESS ENTERPRISE CENTRE
GREEN CONNECTIONS**

December 13, 2010

**Advantages and Disadvantages of
Incorporating as a Not-for-profit**

By Ryan M. Prendergast, B.A., LL.B.

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OVERVIEW OF TOPICS

- Introduction
- Nature of Not-for-profit Organizations
- Non-profit Status Under the ITA
- Maintaining Non-profit Status
- Charities and Not-for-profit Organizations
- Nature of Unincorporated Association
- Benefits of Incorporation
- Disadvantages of Incorporation and Liabilities
- New Federal and Provincial Corporate Legislation

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NATURE OF NOT-FOR-PROFIT ORGANIZATIONS

- Not-for-profit Organizations – Key Concepts
 - What is a not-for-profit under the *Income Tax Act* (“ITA”) (technically a “non-profit organization”)?
 - Club, society or association
 - In the opinion of the Ministry was not a charity
 - Organized and operated exclusively for social welfare, civic improvement, pleasure or recreation, or any other purpose, except profit
 - No part of the income can be payable or available for the personal benefit of any proprietor, member or shareholder

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- What are the legal forms available for non-profit organizations?
 - Corporation with share capital
 - Corporation without share capital
 - Unincorporated Association
- Examples would include
 - Recreational clubs
 - Service clubs
 - Trade associations
 - Professional associations

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NON-PROFIT STATUS UNDER THE ITA

- What are the tax advantages of being a non-profit organization under the ITA?
 - A non-profit organization does not pay tax on income or capital gains, except income from property of an organization whose main purpose is to provide dining, recreation or sporting facilities
 - However, a non-profit organization cannot issue charitable receipts for income tax purposes

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MAINTAINING NON-PROFIT STATUS

- Cannot have a profit-earning purpose, even if that profit is to be used for the not-for-profit purposes of the non-profit organization
- It is always a question of fact whether an organization is operating for the purpose of earning a profit
 - Profit is generally considered to be the positive difference between an organization's revenue and the expenses incurred to earn that revenue
- Important not to be considered a charity in the opinion of the Minister of Revenue
- No appeal from Minister's decision, it is therefore customary to include a purpose in the objects of the corporation that cannot be charitable at law

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- Must meet the definition of a non-profit organization under the ITA on a yearly basis
- Cannot maintain reserves in excess of a reasonable operational reserve
 - Maintaining a large amount of capital solely for the purpose of generating income to support the organization will prevent the organization from being tax-exempt under paragraph 149(1)(l)
- Must file a T2 Return if incorporated
- If the organization has income greater than \$10,000 or assets exceeding \$200,000, it must file a T1044 NPO Return

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- What happens in the corporation no longer qualifies for tax exempt status?
 - Just because a non-profit organization was not reviewed for several years does not mean that CRA accepted that you were entitled to the exemption
 - If audited, each year would be examined separately to determine whether the non-profit organization qualified for the exemption each year
 - A non-profit organization can be re-assessed 3 years in the past, or, if there has been a misrepresentation, the corporation can be reassessed at any time

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- Subsection 149(10) of the ITA will apply at the time the corporation ceases to be a 149(1)(l) entity and provides that the non-profit organization's taxation year will end immediately before that time
- A new taxation year of the corporation is deemed to have begun at that time
- Property of the corporation will be deemed to have been disposed of at fair market value
- 149(10) applies only if the organization is incorporated

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IDENTIFYING THE DIFFERENCES BETWEEN CHARITIES AND NOT-FOR-PROFIT ORGANIZATIONS

- Charities - Key Concepts
 - What is a charity?
 - At common-law a charity includes
 - Relief of poverty
 - Advancement of education
 - Advancement of religion
 - Other purposes beneficial to the community recognized by the courts

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- What are the tax advantages of being a charity?
 - A charity does not pay tax on income or capital gains
 - A charity can issue charitable receipts to donors as tax credits (for individuals) deductions (for corporations) for income tax purposes
 - A gift for income tax purposes now permit consideration to be received back by the donor (split-receipting)
- What are the legal forms available for a charity?
 - Unincorporated associations
 - Charitable trusts
 - Non-share capital corporations

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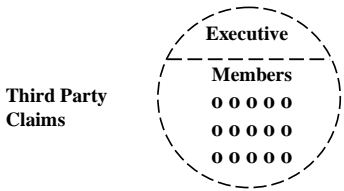
NATURE OF UNINCORPORATED ASSOCIATION

- It is not mandatory for a not-for-profit organization to incorporate to receive the exemption under paragraph 149(1)(l) of the ITA
- An unincorporated association is a voluntary association of individuals
- No separate existence apart from members
- Not a legal person
- No ability to own property in its name
- No separate protection from liability for members

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- Cannot sue or be sued in the name of the association
- Personal liability of members for torts committed by other members or agents of the association and contracts of the association



Third Party Claims

Executive

Members

• • • • •

• • • • •

• • • • •

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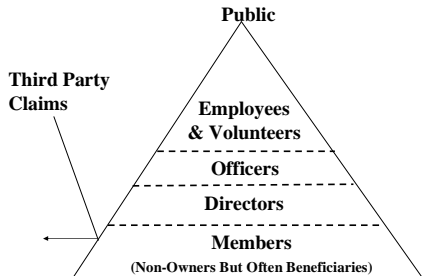
BENEFITS OF INCORPORATION

- Separate legal entity apart from its members
- Perpetual existence
- Limited liability of members (but does not obviate due diligence)
- Allows for indemnification of directors and officers
- Capacity to commence and defend legal actions in its own name
- Can hold property in its own name

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- Directors may be still exposed to personal liability from fiduciary and management responsibilities



Public

Employees & Volunteers

Officers

Directors

Members
(Non-Owners But Often Beneficiaries)

Third Party Claims

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PROCESS OF INCORPORATION

- A note about incorporating under not-for-profit legislation
 - Whether an entity qualifies for the tax exemption can only be determined once the entity is established, has been operating and has filed a tax return
 - An organization can be incorporated under a federal or provincial statute that uses the term “not-for-profit” but still not qualify for the tax exemption

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1. Steps prior to applying for incorporation
 - Essential to approach incorporation with due diligence
 - May want to set up an incorporation committee
 - Draft main corporate documents (constitution)
 - Application for letters patent
 - General operating by-law

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2. Filing documents with appropriate federal or provincial authority
3. Steps following granting of letters patent
 - Initial organization of corporation
 - Meeting of first directors (applicants for incorporation)
 - Formally adopt general operating by-law (“GOBL”)
 - Adopt a borrowing by-law
 - Adopt banking resolution
 - Confirm applicants for incorporation as first members

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- Meeting of first members (same as first directors)
 - Approve passing of GOBL
 - Elect first directors as directors until first annual meeting of new corporation
- Government filings
 - If incorporated federally, must complete notice of federal corporation operating in Ontario

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APPLICATION FOR LETTERS PATENT

- Applicants for incorporation
 - Become first directors of corporation
- Objects (purposes, objectives) of corporation
 - Set out legal parameters in which corporation can function
 - Establishes not-for-profit objectives
- Power clauses
- Dissolution clause – remaining assets cannot be distributed to members or the organization will not qualify for exemption under paragraph 149(1)(l)

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GENERAL OPERATING BY-LAW (GOBL)

- Section 129 of the *Corporations Act* (Ontario) permits GOBL of a corporation to deal with the following matters:
 - Admission of members, membership dues, suspensions, membership certificates, qualifications of directors, timing of director elections, appointments of officers, agents and employees of the corporation, notice, etc
 - Can determine membership structure, i.e., open, closed
 - Terms for directors to serve, etc

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DISADVANTAGES OF INCORPORATION

- Corporation must comply with the statute under which it was incorporated, either the *Corporations Act* (Ontario) or the *Corporations Act* (Canada)
- Must complete annual filings
- Liability risks for directors and officers
- Liability risks for individuals, directors, officers, etc. can arise at common law and by statute
- You cannot eliminate risk, but you can manage the risk
- I will be doing a high level review of some of the risk management issues that should be considered

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- Who are the directors?
 - A director is generally anyone who takes on the role of the directing mind of a corporation
 - An officer carries out the day-to-day functions of the corporation at the direction of the board of directors
 - An officer can also be a director or can become a *de facto* director and then become subject to the same fiduciary obligations
 - For purposes of this presentation, reference to directors is deemed to include officers unless stated otherwise

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- Common law duties and liabilities
 - Management of the corporation
 - Directors are responsible for all aspects of the corporation's operations. They must:
 - Ensure the aims and objectives of the corporation are properly carried out
 - Set long-range objectives and strategic plans for the corporation
 - Provide authorization and general supervision for the activities of the corporation

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- Ensure the corporation's financial stability and overall performance
- Hire and supervise management and staff to do the day-to-day work

– Duty of Care

- Directors of all corporations must exercise a certain standard of care in carrying out their duties
- Most corporate statutes set out this standard as the duty to exercise the "care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances"

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- "Business Judgment Rule": protects directors and senior officers against hindsight and second guessing by members and other stakeholders
- i.e. The court will defer to the business expertise of the directors and will not interfere with reasonable business decisions

– Directors therefore need to ask themselves:

- Have they analyzed and understood the issue before them?

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- Have they retained independent advisors or advisors recommended by management and do the advisors have the requisite expertise and experience?
- Have they tested and challenged their advisors, or merely followed recommendations without question?
- Is the amount of time that they have spent on the issue proportionate to its importance and complexity?

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- Liability Risk in Contract
 - Directors are generally not personally responsible for contracts they sign for the corporation, provided they have the proper authority to do so, which is determined by the corporation's governing documents or by board resolutions
 - However, directors of corporations may face potential liability where:
 - They enter into a contract lacking the necessary authority to do so

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- They do not properly identify the corporation in any contract or to the contracting party
- The other party believes the director is signing in his or her own name
- They are found to have induced a breach of contract prior to the signing of the contract
- They do not follow through to ensure that the corporation complies with a contract
- To reduce liability exposure, directors should ensure contracts are duly authorized by the board before entering into them

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- Continuation of Duties
 - Directors have continuing obligations to the corporation which cannot be relieved by resignation
 - Resignation to avoid personal liability may be ineffective and constitute a breach of fiduciary duty where the director puts own interests ahead of those of the corporation

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STATUTORY DUTIES & LIABILITIES

- Many federal and provincial statutes impose specific offences and penalties for acts and omissions committed by directors
- Purpose of such liability on directors is that the corporation cannot be sufficiently punished itself, therefore its directors must be exposed to the same liability as the corporation
- Legislation imposes liability on directors and *de facto* directors

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- Offences are strict liability offences, meaning it is immaterial whether or not the directors intended that the corporation violate the statutory provisions in question
- Only defence that can be established is one of “due diligence”, which requires that the directors be able to prove to the satisfaction of a court that the directors have taken reasonable steps in the circumstances to ensure that the provisions of the Act in question could have been complied with

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- Penalties for non-compliance with statutory requirements can result in directors being subject to fines, repayment of debt and even imprisonment
- While the focus of this summary is the federal and Ontario jurisdictions, business corporations either located or operating in other provinces must also review the comparable provincial legislation and statutory obligations

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- Federal Statutes
 - ITA
 - Directors jointly and severally liable for:
 - Failure to remit employee deductions
 - Failure to comply with numerous reporting requirements under the ITA
 - Making false or deceptive statements in any return required under the ITA or wilfully evading compliance with the ITA

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- *Excise Tax Act*
- *Canada Pension Plan*
- *Canadian Environmental Protection Act*
- *Criminal Code*
- Ontario Statutes
 - *Corporations Act*
 - *Employment Standards Act*
 - *Retail Sales Tax Act*
 - *Workplace Safety and Insurance Act*

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- *Pension Benefits Act*
- *Health Insurance Act*
- *Employer Health Tax Act*
- *Occupational Health and Safety Act*
- *Environmental Protection Act*
- Businesses need to determine what legislation applies to their industry and review the liability provisions

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NEW CORPORATE LEGISLATION

- *New Canada Not-For-Profit Corporations Act (CNCA)*
 - Received Royal Assent June 23, 2009
 - Not yet proclaimed in force – current estimate is sometime in 2011

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- *New Ontario Not-For-Profit Corporations Act (ONCA)*
 - On October 25, 2010, Bill 65, The *Ontario Not-for-profit Corporations Act* ("ONCA" or the "Bill") received Royal Assent
 - It is not expected to be proclaimed until sometime in 2012
- Continuing under the CNCA
 - All existing CCA corporations will be required to continue under the CNCA within 3 years of it coming into force or face possibility of dissolution (s.297)
 - Content of articles of continuance similar to articles of incorporation under s.7

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- Can make amendments to its articles, letters patent or memorandum or articles of association, at the same time as applying for continuance (s.211(2))
- Continuing under the ONCA
 - Existing OCA corporations will be required to continue under the ONCA within 3 years of it coming into force (s. 207)
 - Social clubs with share capital will have 5 years (s.211)
 - OCA corporations can, by articles of amendment, amend any provision in its letters patent, supplementary letters patent, by-laws or special resolution to bring the provision into conformity with the ONCA (s.207)

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